Client Update
Public Company M&A in the Insurance Sector—Current Legal and Strategic Issues Spring 2017

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The insurance M&A market has been choppy over the last few years, with 2016 showing a noticeable drop-off from a very busy 2015. One part of the market, however—public company M&A—has been consistently robust. In the past, many public insurance deals were stock-for-stock deals between strategic parties, sometimes styled as mergers of equals. We are now experiencing a very different trend. Of the 10 largest public deals announced in 2015 and 2016, eight were ultimately all-cash deals and nine involved a buyer that would have been considered nontraditional just a few years ago. The definition of "nontraditional" is of course quite fluid, but, in this category, we include Japanese buyers (Sompo, Tokio Marine, Dai-Ichi Life, Meiji Yasuda and Sumitomo Life), Chinese buyers (Anbang and China Oceanwide), a Canadian consolidator and a pension fund (Fairfax Financial backed by OMERS) and a large, diverse, family office (Exor).

This article explores what this trend means for the insurance M&A market. Specifically for boards of directors, management teams and advisors that may be considering a sale process, what are the key issues raised by the emergence of this non-traditional buyer pool? In particular, we will look at the questions of "reverse" due diligence (*i.e.*, what a board should be asking about potential buyers' ability to complete a deal); contractual allocation of regulatory risk (*i.e.*, once a deal is announced, how to mitigate the risk that it might not close because of a failure to obtain regulatory approval); and fiduciary issues for directors when conducting a process for a sale of control for cash to a nontraditional buyer.

RECENT PUBLIC DEALS

The most prominent recent public insurance M&A deals have included the following:[1]

Deal	Consideration
Target Company: Endurance Specialty Holdings Ltd. Buyer: Sompo Holdings, Inc. Signed: October 5, 2016 Closed: March 28, 2017	Price: $6.3 billion in cash Premium: 43.2% above target company's price before press release in Japan
Target Company: PartnerRe Ltd. Buyer: Exor S.p.A. Signed: August 2, 2015 Closed: March 18, 2016	Price: $6.9 billion in cash Premium: 23% above the target company's price before announcement of the AXIS merger
Target Company: Stancorp Financial Group, Inc. Buyer: Meiji Yasuda Life Insurance Company Signed: July 23, 2015 Closed: March 7, 2016	Price: $5.0 billion in cash Premium: 48% above the target company's price before signing
Target Company: Symetra Financial Corp. Buyer: Sumitomo Life Insurance Co. Signed: August 11, 2015 Closed: February 1, 2016	Price: $3.8 billion in cash Premium: 30.2% above the target company's price before release of media reports

[1] Debevoise & Plimpton LLP has represented a principal, a competing bidder or a financial advisor in seven of these 10 deals; however, the information contained in this article is derived entirely from public sources.

Deal	Consideration
Target Company: The Chubb Corporation Buyer: ACE Limited Signed: June 30, 2015 Closed: January 14, 2016	Price: $29.5 billion Premium: 32% above the target company's price before signing
Target Company: HCC Insurance Holdings, Inc. Buyer: Tokio Marine Holdings, Inc. Signed: June 10, 2015 Closed: October 27, 2015	Price: $7.5 billion in cash Premium: 37.6% above the target company's price before announcement
Target Company: Protective Life Corporation Buyer: The Dai-ichi Life Insurance Company, Limited Signed: June 3, 2014 Closed: February 1, 2015	Price: $5.7 billion in cash Premium: 34% above the target company's price before release of media reports
Target Company: Allied World Assurance Company Holdings, AG Buyer: Fairfax Financial Holdings Limited Signed: December 18, 2016 Closed: Pending	Price: $4.9 billion Premium: 18% above the target company's price before signing

Deal	Consideration
Target Company: Genworth Financial Inc. Buyer: Asia Pacific Global Capital Co., Ltd. (China Oceanwide) Signed: October 21, 2016 Closed: Pending	Price: $2.7 billion in cash Premium: 4.2% above the target company's price before announcement
Target Company: Fidelity & Guaranty Life Buyer: Anbang Insurance Group Co., Ltd. Signed: November 8, 2015 Closed: Pending	Price: $1.6 billion in cash Premium: 28.9% above the target company's price before announcement of potential sale by controlling shareholder

The premiums paid in these deals have often been compelling and, where the premiums have been less than stellar, there have been important strategic reasons driving the seller's board to pursue a deal. The target companies have followed different processes—often conducting pre-announcement market checks and, in some cases, a post-announcement "go-shop" allowing the target company to solicit competing bids after signing a merger agreement—but the market has moved away from traditional auction processes. Regulatory risk has been handled differently—with key topics of negotiation including the definition of "burdensome condition" (regulatory conditions a buyer is not contractually obligated to accept) and the use of a reverse termination fee ("RTF") payable by the buyer to the target in the event that a buyer does not obtain the required regulatory approvals.

As is often the case, the rule that emerges from an analysis of these deals is that there is not any one road map that directors must follow to be sure they have complied with their fiduciary duties and get to a successful closing. Nevertheless, a decision to pursue the sale of a public company is among the biggest decisions a board can make. The balance of this article will provide some points we hope are useful to directors and their advisors as they evaluate that option in the current market.

REVERSE DUE DILIGENCE

There are at least three key questions that target company directors should consider asking when evaluating a potential transaction with a nontraditional buyer:

- Who is this buyer?
- Does it have the financial resources needed to do the deal?
- Will it get to a closing, and what happens if it doesn't?

The first question relates to issues similar to those that arose when private equity firms first began to move into the life and annuity M&A market. Does this buyer have experience running an insurance business? What are its plans for the company? Does it understand the U.S. regulatory process? Is there an individual person or group of individuals who controls the buyer, or is it a publicly traded or widely held firm? Important also is the question of governmental control or ownership—is this a buyer that will have trouble receiving approval in a state that restricts governmental ownership (though governmental ownership restrictions are technically licensing rules, not surprisingly we have seen them imported into the Form A process)? Are there likely to be CFIUS issues or issues with the buyer's capital structure or other businesses that may cause rating agency concerns? Does the buyer have a suite of advisors that can help guide it through the U.S. regulatory process?

The second question has two components: where a buyer is a private company or otherwise provides little public information about its finances, can a seller be certain that the buyer has adequate financial resources to close the deal? Even in a deal with no financing contingency, the prospect of a failed transaction leading to even a successful a lawsuit against an inadequately capitalized buyer is not a particularly satisfying outcome. Even where the buyer has funding, what is the source of that funding? Recent news from China, for example, has created uncertainty about the ability of Chinese buyers to move large amounts of currency out of China as a consequence of the application of increased Chinese foreign exchange ("SAFE") restrictions. Should the buyer be required to deposit some cash in a U.S. bank account as "earnest money" to support its commitments under a merger agreement?

Finally, even if the buyer is a reputable organization with sufficient funding, will it be able to get through the regulatory process both in the United States and also in its home jurisdiction? Or will there be some risk that the buyer fails to close and the target is left with nothing but a lawsuit alleging failure to use appropriate efforts to obtain regulatory approvals?

An example of intensive reverse due diligence can be found in Anbang Insurance Group Co, Ltd.'s $1.6 billion acquisition of Fidelity & Guaranty Life (which has yet to close). In that deal, the target chose to focus on addressing its concerns about Anbang's ability to obtain regulatory approvals primarily through due diligence rather than through contractual terms. Before executing definitive agreements, FGL reviewed drafts of Anbang's change-of-control regulatory filings, and representatives of FGL and Anbang met with officials at both the Iowa Insurance Division and the New York Department of Financial Services. In the end, these discussions—and the fact that Anbang's proposed price was the highest across all bidders (a 28.9% premium)—gave FGL's directors the comfort they needed to proceed with the transaction. Subsequent amendments to the merger agreement have been layered in contractual terms that allow FGL to seek competing offers.

These reverse due diligence questions are all valid and reasonable questions for a target company board to ask before announcing a sale of the company to a nontraditional buyer. The next question, even where diligence has been thorough, is how completion risk should be allocated between the parties in a merger agreement.

ALLOCATION OF REGULATORY RISK

Every insurance M&A deal includes an element of regulatory risk. Where the buyer and seller are both regulated insurance holding companies, that risk is customarily dealt with by a relatively straightforward buyer covenant to use reasonable best efforts to obtain regulatory approval and a limited out in the event that regulators impose unduly burdensome conditions to the grant of those regulatory approvals. This was the case, for example, in the Chubb-Ace merger, where the covenant to receive regulatory approvals simply required "reasonable best efforts" and the burdensome condition language provided an out only for "condition[s] or restriction[s] that would reasonably be likely to have a material and adverse effect on [Ace] and its Subsidiaries, taken as a whole, giving effect to the Merger"—a very high standard.

In the case of nontraditional buyers, the story is very different, and there are at least three issues that come up repeatedly.

First, the target's directors will want to evaluate the regulatory approvals required to close the deal not just in the target's jurisdictions of domicile, but also in the buyer's home country. For example, in transactions with Japanese buyers it is generally the case that Japanese Financial Service Authority ("JFSA") approval is required in order for the buyer to acquire a foreign subsidiary. The

same is true for Chinese buyers—both the Anbang/FGL deal and the Genworth/China Oceanwide deal included certain PRC approval requirements (such as the approval of the China Insurance Regulatory Commission ("CIRC")) before the transaction can close. What comfort can a target get that these home country approvals will not serve as a sort of "back-door" option on the part of the buyer not to close if conditions turn against the transaction? In the Genworth transaction, Genworth negotiated an RTF requiring Oceanwide to pay 7.8% of deal value if the merger failed to close as a result of failure to obtain regulatory approvals in China, Hong Kong, Macau or Taiwan; the full amount of that RTF was funded into escrow.

Second, what regulatory limitations will the buyer be obligated to accept? This issue comes most pointedly to the table in the debate about the definition of "burdensome condition." As noted above, transactions between strategic parties, such as Ace and Chubb, have tended to require that a very high standard be met before a buyer would be excused from closing—the regulatory burden must amount to a material adverse effect. This makes sense because both parties are large firms well known to insurance regulators, with the risk that regulators would impose unreasonable burdens being considered modest. Where a buyer is nontraditional, however, we have seen insurance regulators take a much more expansive view of their role in ensuring that the post-closing control structure is closely monitored and seeking to impose conditions on the parties prior to approving an acquisition of control. With that risk in mind, nontraditional buyers will often seek to negotiate clear limits on the requirements they must accept. A good example is the issue of required contributions of additional capital to an insurance business. In the Genworth transaction, for example, the parties agreed that a "burdensome condition" would be triggered if regulators required a contribution to capital in the insurance business in excess of certain pre-agreed threshold amounts, including $525 million in agreed capital designed to facilitate the de-stacking of Genworth's life and annuity business from under its troubled long term care business.

Finally, there is the open and evolving question about whether and in what circumstances a buyer will agree to pay any form of regulatory RTF. To date, in most cases the answer to this has been a resounding "no." Buyers have argued that the idea of paying a fee in the event that they do not obtain home country regulatory approval is anathematic—and even potentially offensive—to their home country regulators. Buyers that are not insurance companies often point to market precedent and describe the question of regulatory risk as one primarily for the target company to evaluate in deciding whether to pursue the deal. But there are exceptions. For example, Exor's unsolicited $6.9 billion bid for PartnerRe came after PartnerRe had agreed to a merger of equals with Axis

Capital Holdings Ltd. During the course of negotiating with Exor, PartnerRe raised concerns about Exor's ability to obtain regulatory approval in the United States. Although publicly traded and experienced in the financial services sector, Exor was a foreign, family-owned investment company with no presence in the United States insurance sector. In the end, Exor agreed to a limited RTF of 3.2% of purchase price payable if Exor failed to obtain the necessary regulatory approvals, an amount intended to reimburse PartnerRe for the fee it had to pay Axis to terminate their merger agreement. Exor successfully received regulatory approvals, and the transaction closed in March 2016.

SALE PROCESS

It is a well-established principle of Delaware law that directors, when they have determined to sell a company for cash, have a duty (commonly known as a *Revlon* duty) to seek the best price reasonably available. Although the *Revlon* decision used the metaphor of the target board as "auctioneer," subsequent cases have emphasized that there is no single blueprint boards must follow in selling a company, and that courts should decide whether the directors made a reasonable decision, not a perfect decision. The recent deals involving nontraditional buyers serve to demonstrate these points well.

In some cases, nontraditional buyers have expressed an unwillingness to participate in a competitive auction process. This presents a target company board with a dilemma: how to ensure that the board is getting the best price reasonably available, when at least one important potential buyer is clearly stating that it will not participate if the transaction is thrown open to competition.

In addition, it has been our experience that target insurance companies themselves may be predisposed against competitive auction processes, fearing potential damage to their franchise (including rating agency, distribution, employee and regulatory relationships) if it becomes widely known that the company is in play.

Some specific examples will give an idea of how this type of issue can be addressed:

- In both the Protective and Stancorp transactions, there was no formal pre-signing auction process conducted. Rather, the target board negotiated hard to achieve a price that it thought fully reflected the value of the company, and also bargained for a post-signing "go-shop" provision allowing it to seek competing bids for a period after the merger agreement was signed. The go-

shop has been expressly blessed by Delaware courts, so long as the provision is designed to present "a reasonable opportunity of obtaining a better bid." When go-shops are used, typical topics of negotiation include the length of the go-shop period, the size of the termination fee applicable to go-shop bidders (usually it is smaller than the ordinary termination fee payable in the event of a topping bid) and whether the competing bid must be signed, or merely proposed, during the go-shop period to be eligible for the reduced termination fee.

- In the HCC and Symetra transactions, the proxy statements reveal that the target companies had conducted pre-signing market checks they felt sufficient to give them a good sense of the market value of the company. That, combined with a reasonable package of deal protection terms (for example, HCC's board agreed to a "no-shop" provision prohibiting any post-signing solicitation of competing bids in exchange for their right to terminate the merger agreement to accept an unsolicited superior proposal, subject to HCC's payment of a relatively low termination fee of 2.5% of purchase price), gave the target board confidence to proceed with neither a full pre-signing auction nor a post-signing go-shop.
- In the Sompo/Endurance transaction (Endurance is a Bermuda company and thus not technically subject to the same legal regime as a Delaware company), there was neither a pre-signing market check nor a post-signing go-shop period. However, the all-cash price that Sompo offered was so high (representing a 43.2% premium) that Endurance's board of directors was satisfied as to its value and simply negotiated a merger agreement with a customary, non-preclusive set of deal protection provisions, including a 3.2% breakup fee.

In each of these examples, the target company had a compelling reason to proceed with a nontraditional buyer that offered a robust cash purchase price and an acceptable level of regulatory risk. In each case, the target company board employed a mix of procedural steps and contractual provisions to allow it to conclude that it had done its job of obtaining the best price reasonably available for the shareholders.

An outlier among these recent deals was Fairfax Financial Holdings Limited's recent $4.9 billion acquisition of Allied World. Unlike the other "nontraditional" transactions, consideration in the Allied World transaction was not entirely in cash. The consideration instead consisted of $10 cash (inclusive of a $5 dividend) and $44 of Fairfax stock per share (representing, in aggregate, an 18% premium on Allied World's stock price at signing). Because this structure necessitated a vote of Fairfax shareholders, the deal included a termination fee payable by

either party under certain circumstances. In addition, Allied World negotiated for a go-shop provision with a reduced termination fee. Fairfax's financing for the Allied World deal was an item of negotiation as well—while the aggregate consideration paid to Allied World shareholders would be the same, the cash consideration paid would depend on the amount that Fairfax could raise from co-investors. The parties subsequently announced a financing partner that allowed the cash portion of the consideration to increase to $23 per share (inclusive of the $5 dividend) with a corresponding decrease to the stock portion of the consideration.

CONCLUSION

What can we conclude from these recent public company transactions? First, nontraditional buyers are to a very large extent driving the current U.S. insurance M&A market and are doing so by putting forth some impressive price premiums. Target companies are concerned about regulatory risk with respect to these buyers and are developing increasingly creative ways to address this risk. These include detailed reverse due diligence and thoroughly negotiated risk allocation provisions in the merger agreement. In addition, nontraditional buyers may be unwilling to participate in competitive pre-signing auction processes, and so we are seeing thoughtfully designed sale processes that allow directors to elicit high valuations and comply with their fiduciary duties. We expect these developments will continue to shape the insurance M&A market as boards and their advisors continue to look for ways to create shareholder value in the face of changing market dynamics.

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Please do not hesitate to contact us with any questions.