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HOSTILE TAKEOVERS, PROXY FIGHTS AND INSURANCE HOLDING COMPANIES

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Although hostile takeover attempts in the insurance industry have been infrequent in the last 30 years, the environment may be changing. In 2015, several announced insurance mega-mergers (ACE /Chubb, Anthem/Cigna, Aetna/Humana) left insurer boards of directors wondering if they should be next in line to merge, or if they would be next up on another company's radar screen. These deals followed close in time after Endurance Specialty Holdings' hostile overtures to Aspen Insurance Holdings in 2014, and at the same time as Exor SpA's hostile overbid for PartnerRe Ltd. In addition, the well-publicized challenge by Carl Icahn to AIG's strategic direction also may have left some insurers looking over their shoulders. Even if not hostile takeover targets, insurers now are more often finding themselves under the unaccustomed scrutiny of activists.

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Fortunately, because of their special role as the nation's long-term promise keepers, insurers have some additional potential insulation from hostile takeovers and proxy fights. This article will review the special considerations that apply to hostile takeovers and proxy fights involving insurance holding companies.

Issuer Responses to Unsolicited Proposals

Most unsolicited offers do not result in a hostile takeover attempt. Many would-be acquirers go away after being told no, while in other cases such an offer leads to a negotiated deal, with the original offeror or a third party. Likewise, it seems that with increasing frequency, companies are not doing all-out battle with activist investors, but instead are creating space on the board for one or two nominees without going through a proxy fight. AIG's agreement to put two activists on its board is one prominent recent example. Sometimes these situations work out well; the new directors provide energy and a fresh perspective, and work well with management and the existing board. In other situations, the appointment of new directors leads to a change in senior management or a sale of key assets or the whole company to achieve a short-term result favored by a difficult and vocal advocate.

When a board is presented with an offer it believes is too low, or with proposed insurgent board members focused on an ill-conceived strategic transaction or change in management, the attitude of the board will often be defensive. In this situation, the board may try to use all appropriate means to resist the proposal.[1] These companies are likely to engage in protracted fights, both about big picture issues such as the issuer's long-term strategy and value and (in an exchange offer) the synergies or dis-synergies that the deal would produce, as well as nitty-gritty legal issues like compliance with nomination procedures and the accuracy of Schedule 13D and proxy disclosure.

For companies that own a U.S. insurance company subsidiary, an additional layer of analysis applies. Insurance holding company laws in the 50 states and the District of Columbia impose pre-conditions on the acquisition of "control" of an insurer. These laws also apply to the holding company for an insurer, if the holding company is "primarily engaged" directly or indirectly in the business of insurance. A person may not acquire "control" of the insurer or the holding company unless approved by the applicable state authorities, whose review includes, among other things, a determination that the competence, experience and integrity of the proposed controller and its board designees satisfy statutory standards, as well as consideration of an acquirer's plan for operating the insurer and for financing the acquisition. These rules may provide a basis for opposing an unwanted takeover or, in a proxy fight, derailing potential board nominees whose service would be viewed unfavorably by the target's board.

Who's in "Control" (in Insurance World)

Like many "control" definitions in corporate law, the definition of control in the various insurance holding company acts typically is not very precise. The NAIC Model Insurance Holding Company System Regulatory Act (the "Model Act"), which has been adopted in whole or in part in almost all states, says that control means "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 other than a commercial contract for goods or nonmanagement services, or otherwise." The Model Act goes on to say that "[c]ontrol shall be presumed to exist if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person," although that presumption may in appropriate circumstances be rebutted by a showing that control does not exist in fact. Over the years, numerous state insurance regulators have provided their own glosses on the definition of control, which do not always line up exactly with the words of the relevant statute. These interpretations also cover situations in which the 10% presumption may be rebutted and requirements for such rebuttals. In each case, however, if "control" would exist, its acquisition may not occur without pre-approval. Notwithstanding these different interpretations, this article will focus on the Model Act to give a general overview of the prevailing situation.

By definition, the hostile acquisition of 100% of the stock of an insurance holding company is an acquisition of control, requiring pre-approval of the insurance regulator in each state in which an insurance-issuing subsidiary of such holding company is organized. In addition to such states of domicile, the transaction will also require approval from any state in which an insurer is "commercially domiciled." The latter refers to the laws of a few states (most notably California) which treat companies that generate a significant amount of their business in such second state as though they were legally domiciled there.

However, some hostile takeovers may involve a potential "acquisition of control" for regulatory purposes that occurs long before a tender offer is commenced. Takeover proponents will oftentimes start with a bear-hug letter and then move right to a proxy fight to unseat the incumbent board and replace it with directors inclined to a sale. This approach may avoid defenses such as poison pills, saves the costs and frictions associated with filing and circulating a tender offer statement and is sometimes successful in achieving the goal of getting the target's board to negotiate a deal with the acquirer. Likewise, an "acquisition of control" may potentially occur where an activist shareholder seeks significant board representation to affect a company's strategic direction, as opposed to trying to buy the company.

To explore the potential impact of the "insurance regulatory defense" on proxy fights in general, it will be helpful to separately consider nominations put forward by holders of 10% or more of an issuer's stock and by holders of less than 10%.

10% Holders

Under the Model Act, as described above, the holder of 10% or more of the voting securities of an insurance holding company is presumed to be in control. In many states, the term "voting securities" can include convertible securities; therefore, holders may need to aggregate their positions in common stock, convertible preferred and even convertible debt for purposes of evaluating whether they reach the 10% threshold. Rebutting this presumption of control generally requires filing a disclaimer of control with the applicable authorities and having it approved. Approval of a disclaimer of control is a question of facts and circumstances as to whether the shareholder in fact is in a position to exert control over the insurer. One of the key items that insurance regulators have considered in determining whether control exists with a holder of 10% or more of the insurance holding company's voting securities is whether the holder has representation on the board of directors of the insurer or its holding company. Further, certain states (New York being one example) may require the holder to sign a standard form of commitment letter as a condition to the approval of a disclaimer. Among other things, the New York form of commitment letter includes promises from the shareholder that it will not:

- Propose a director in opposition to a nominee proposed by the board of the holding company;
- Seek or accept representation on the board of the holding company (as a representative of the shareholder);
- Solicit proxies with respect to any matter presented to the shareholders of the holding company; or
- Attempt to exercise, directly or indirectly, a controlling influence over the management, policies or business operations of the holding company.

As a result, a 10% or greater shareholder seeking

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representation on an insurance holding company's board may be required to file and have approved a change of control application on Form A with respect to an acquisition of control, or at minimum a disclaimer[2] (or amended disclaimer) with respect to its share ownership. Which of these two requirements would apply will depend on the rules and practices of the state or states where the relevant insurers are domiciled.

Holders of Less Than 10%

Although not as clearly covered by the Model Act, a holder of less than 10% may also be a control person. First, under the Model Act, "control" includes holding proxies representing 10% or more of the voting stock of a company. Plainly, any shareholder seeking election of a director would at some stage prior to the election have to hold proxies covering a number of shares well in excess of 10% of the outstanding stock. Moreover, even apart from the "proxies" prong of the Model Act's control presumption, the ownership of less than 10% of the outstanding stock, when coupled with significant representation on the holding company's board or other attempts to influence control over the company, has in certain cases been enough to trigger Form A or disclaimer requirements.

Unconventional Pressure Approaches

Rather than actually run a proxy fight, third parties will sometimes use unconventional approaches to pressure incumbent boards. These include letter-writing campaigns, like Icahn's public letters critical of AIG. They may also include unusual shareholder referenda. In its attempt to take over Aspen, Endurance filed with the SEC and circulated to Aspen stockholders a consent solicitation statement. The document sought non-binding shareholder support for (i) the board of Aspen to increase the size of the board from 12 directors to 19 directors (with the vacancies to be filled by a stockholder vote at a later date) and (ii) the making of a proposal by Endurance for an acquisition.

Although these sorts of tactics do not result (at least immediately) in the proponent holding proxies or getting directors elected, they too might potentially be viewed as effecting an "acquisition of control" for insurance regulatory purposes. For example, New York requires that 10% or greater stockholders not attempt to exercise a controlling influence over the management, policies or business operations of the holding company without filing a Form A. This requirement from the standard commitment letter could as well be applied at lower levels of share ownership. According to the commentary to the Model Act,[3] control is broadly defined to include any method, direct or indirect, by which business may be directed by any person not in an official capacity with the organization. The words "any method" have on at least some occasions in the past been viewed by regulators as broad enough to cover unconventional approaches which have as their goal the acquisition or disposition of insurers or a significant stockholder's gaining board representation.

Form A Requirements

Any hostile takeover acquirer has to be ready to get an acquisition of control application on Form A approved in each relevant state, as described above, and so would at least be ready to try to do so, or to challenge the Form A requirements in court (discussed further below). By contrast, the need to have a Form A approved may be a daunting prospect for many activists that might otherwise consider seeking the election of their directors. The sheer amount of paperwork involved and the time and expense required to be approved as a controller of an insurance company may lead them to look for easier targets to influence. Further, in some states, a Form A requires a mandatory public hearing. The consequences of being an approved controller can also be significant. These include requirements to provide annual financial and other updates to the insurance regulators. Transactions between any member of the holder's holding company system (which would include a PE fund's portfolio companies, unless an exemption is obtained) and a controlled insurer can be subject to prior approval.

Insurers, by the nature of their business, make long-term promises to pay money, often to individuals and small businesses. Much insurance regulation is devoted to ensuring that they will be able to keep those promises, and not be harmed by poor management or the squandering of assets. In considering an acquisition of control, the Model Act calls for the regulator to consider, among other things, whether the plans or proposals of the proposed controller are unfair and unreasonable to policyholders and not in the public interest; the competence, experience and integrity of the proposed control persons; and whether the acquisition of control is likely to be hazardous or prejudicial to the insurance-buying public. These considerations allow the regulators to take into consideration things such as whether the proposed controller might directly or indirectly harm the financial well-being of the insurer. The amount of debt proposed to be used by an acquirer, which debt would rely on insurance company distributions as the key source of debt service, has been a consideration that regulators have taken into account in determining whether to allow a takeover; indeed, a few states have regulations or desk drawer rules on the permitted level of acquisition leverage. The past business conduct and current business operations of the bidder are also relevant considerations. Further, though not as clearly stated in the Model Act, regulators have been influenced by the potential impact on jobs in their home state, reasoning that job losses may adversely impact the insurer's policyholders and the public interest. It can be anticipated that insurance company issuers will make a range of arguments focused on the foregoing criteria if faced with an undesired nominee.

Schedule 13D Filers Beware

One indicator of control that state regulators have considered in the past, for holders of both more and less than 10% of an issuer's stock, is whether the holder has filed a Schedule 13D with respect to the issuer. Any holder of 5% or more of the stock of a public company is required to file a Schedule 13D to report its holdings and describe its plans with respect to the issuer. An exception is available for certain passive investors, who hold their shares without the purpose or effect of changing or influencing the control of the issuer. These passive investors may instead report their stock ownership on Schedule 13G, a shorter form which requires substantially less disclosure. State regulators have looked to the prior existence of a Schedule 13D filing, as opposed to a Schedule 13G filing, as an expression of a holder's intent to control the issuer.

Further, the nomination of a director is generally an event that causes a passive investor to no longer be entitled to file a Schedule 13G. This change in filing status plays into the hands of an insurance holding company seeking to defend against an insurgent who proposes a director nominee.

Federal Preemption Arguments

In the context of hostile takeovers of insurance holding companies, or proxy fights over representation on the boards of such companies, the question of whether the federal securities laws preempt state insurance holding company acts, or whether the holding company acts are in conflict with the Commerce Clause of the U.S. Constitution, has been the subject of substantial litigation. Although these questions have perhaps not been definitively answered, there is substantial authority on the side of no preemption.[4] *Hoylake Investments Ltd. v. Washburn*[5] is typical of these cases. The *Hoylake* case arose out of the hostile bid of Sir James Goldsmith for B.A.T. Industries, a multinational company incorporated in England that among other things was the owner of Farmers Group, Inc., a major U.S. insurance group. Hoylake, which was Goldsmith's investment vehicle, challenged the various states' versions of the Model Act on Commerce Clause grounds, among other bases. The *Hoy-*

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lake court found that the McCarran-Ferguson Act protected the Illinois version of the Model Act from Commerce Clause challenge. Finding first that the McCarran-Ferguson Act protected state laws that regulate "the business of insurance" from Commerce Clause challenge, the court then determined that regulation of changes of control of insurance holding companies is part of the regulation of the "business of insurance." The court reasoned that the Model Act is designed to protect policyholders' interests by protecting the insurance company from unscrupulous or inexperienced management. In so doing, the court reached the same conclusion as the U.S. District Courts in two other states that were presented with similar challenges by Goldsmith.

State Corporation Law Considerations

A full discussion of the state corporation laws that apply to a hostile takeover defense or proxy fight is beyond the scope of this article. However, it is important to bear in mind that the insurance regulatory "defense" only comes into play once the target's board has determined that a defense should be mounted in order to fulfill its fiduciary duties to stockholders. In the hostile takeover context, this raises familiar considerations of the *Unocal* doctrine.[6] If a board adopts defensive measures to repel hostile actions, it must show: (1) that it had reasonable grounds to believe that the hostile takeover attempt threatens corporate policy and effectiveness; and (2) that the defensive actions the board adopted are reasonable relative to the threat.

The steps a corporation can take to avert a proxy contest are not unlimited; state corporate laws protect the stockholders' interest in a fair election. Delaware's law on the subject includes two somewhat different, yet overlapping, standards that have been applied by the courts. The *Blasius*[7] line of cases requires corporate boards to demonstrate a "compelling justification" for any action, the primary purpose of which is to interfere with or impede the shareholder franchise. The cases applying *Blasius* have almost all found that the incumbent's conduct did not meet this high standard. *Unocal* and its progeny have also been held to apply to election contests, including where less than a majority of the board was at stake.[8] In contrast to *Blasius*, the *Unocal* standard requires directors first to show that their action served a legitimate corporate objective, and then that the action was reasonable in relation to the objective and would neither preclude stockholders from exercising their voting rights, nor coerce them into voting a certain way.[9] When a defensive action has the primary purpose of interfering with stockholder voting, the Delaware courts will apply the *Blasius* "compelling justification" requirement within a *Unocal* review.[10] Together, these cases stand for an overall proposition that proxy contests should be a fair fight, without management taking improper advantage of board election mechanics to favor the incumbents. Management needs to be ready to demonstrate that any affirmative steps it takes that thwart the opponent's efforts are in the service of a bona fide corporate purpose and not merely to protect incumbents.

Whether an insurance regulatory defense could be used to shut down a true third-party proxy fight consistent with Delaware case law will depend to some degree on the relevant facts and circumstances. However, as a general matter, it seems unlikely that state corporation laws would favor holding an election in which the board service of one of the candidates would be illegal.[11] A company in this situation might be able to get an injunction, or could even possibly refuse to seat the insurgents, if elected. If an insurance holding company receives a nomination, it should then seek to promptly determine whether the election or service of the nominee would violate any applicable state insurance holding company act. For large insurance groups, this determination may involve an evaluation of the laws (and lore) of a number of states. In some cases the determination may be able to be reached without contacting regulators. However, crossing a threshold where control is presumed is not in itself generally a violation of state law, if control in fact does not exist. Control is a facts-and-circumstances analysis with respect to which the ultimate arbiter is the state regulator (subject to applicable appeals). Therefore, in many cases, it will be important for the issuer to ascertain the view of the regulators and, among other things, whether there have been any relevant communications between the holder and the regulator in advance of the nomination.

But Will the Regulators Act?

Given the foregoing analysis, the key question for insurance holding companies faced with a hostile takeover, or a proxy fight, may be whether the regulators will act to bar the door. In our experience, where regulators have perceived the would-be acquirer or activist as potentially dangerous to the insurer's ability to meet its long-term commitments, there has been a willingness to act. Regulators may also be swayed by potential job losses in their states, which if too drastic can unacceptably weaken an insurer. The job of the incumbent board is to show the regulators the risks posed by the outsider, based on its track record or lack of track record, as well as its proposals for the insurer. A proposal to split up an insurance group that does not make economic sense and is a distraction for management, when management should be focused on improving long-term performance to the benefit of policyholders, is a viable reason for regulators to get involved. Likewise, an outsider's focus on short-term stock price improvement, when an insurer's long-term financial strength is potentially put at risk, is another good reason for a regulator to act. Finally, uncertainty about the future of an insurance holding company can lead to senior management defections and reluctance on the part of agents to place business with the insurer, all of which can be bad for a company and by extension, its policyholders. On the other hand, if an insurgent is benign, has a good track record or is facing management that has stumbled, our experience suggests that, notwithstanding applicable rules or prior practices, the regulators of certain states will not interfere in what the regulators view as the healthy exercise of shareholder democracy.

What Should Insurance Holding Companies Do Now?

Like all public companies, insurance holding companies that would like to avoid the prospect of a proxy fight (whether or not part of a hostile takeover) should first review their by-laws. Advance notice by-law provisions and director qualification standards are the first line of defense in regards to a possible undesired stockholder nominee. By providing information about and time to react to a nomination, these provisions facilitate a thoughtful response by the issuer. They may also, if well-crafted, supply useful information for making arguments to regulators. Although there have been several court decisions in recent years[12] that have had an impact on these provisions, some companies have not yet taken the time to look back at them and update them in light of new developments. Other normal measures apply as well, such as maintaining good communications with stockholders and monitoring the make-up of the stockholder base.

Further, for insurance holding companies with a potential activist holder who may be getting restless, it makes sense to schedule meetings between the company's senior management and the relevant regulators of one or two key domiciliary states, especially if the company has been struggling at all during the last few years. This sort of meeting can help build goodwill and confidence in the company's management and business plan that could be valuable if an undesired nominee is presented.

Finally, if a hostile overture or nomination is received, a company would be wise to hire legal advisors that combine deep knowledge of the securities laws and proxy fights with equivalent experience in insurance regulatory matters. Much of the state law aspect of the situation will depend on relationships with regulators and the relevant unwritten "lore" in

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the particular state, as well as insight into what has worked in other states. Although there may be local advisors who can bring some of this knowledge to bear, without strong corporate and securities expertise it will be difficult to match up this knowledge with the requirements of the securities laws.

ENDNOTES:

[1] As discussed below, tactics available to the board are bounded by state corporation laws.

[2] Many institutional investors are internally set up to track their aggregate ownership of the shares of insurance holding companies and, if they approach presumptive control limits, to file for disclaimers. However, some are not, and it can be anticipated that some issuers would use failures to file by such investors as a basis to cast the shareholder in a negative light with the applicable authorities. Moreover, it may be important for issuers to follow-up with major shareholders who have not filed for disclaimers, so the insurer can accurately fill out its holding company filings, which require disclosure of its control persons, and track possible affiliate transactions.

[3] Proc. of the Nat'l Ass'n Ins. Comm'rs, 1969 vol. 1, at 196.

[4] *E.g., Hoylake Invest., Ltd. v. Washburn,* 723 F. Supp. 42 (D.I11. 1989); *Walden v. Wigen,* 1983 U.S. District LEXIS 15064 (D.N.D. 1983). *But see, e.g., Liberty National Life Ins. Co. v. Huddleston,* 1990 U.S. District. LEXIS 20890 (D. Tenn. May 2, 1990).

[5] *Hoylake*, supra.

[6] *Unocal Corp v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985)

[7] *Blasius Industries, Inc. v. Atlas Corp.,* 564 A.2D 651 (Del. Ch. 1988). The *Blasius* standard has been subject in recent years to some question as to its continuing vitality, at least as a standalone doctrine. *See Keyser v. Curtis*, 2012 WL 3115453 (Del. Ch. 2012); *Kallick v. SandRidge Energy, Inc.,* 68 A.3d 242 (Del. Ch. 2013).

[8] *E.g., Mercier v. Inter-Tel (Del.), Inc.,* 929 A.2d 786 (Del. Ch. 2007)

[9] *See Inter-Tel,* 929 A.2d at 810.

[10] *MM Cos., Inc. v. Liquid Audio, Inc.,* 813 A.2d 1118 (Del. 2003)*; Pell v. Kill,* 2016 WL 2986496 (Del. Ch. 2016).

[11] To provide further protection, issuers should confirm that their director qualification standards bar election of individuals whose election or service would violate applicable law.

[12] *See Jana Master Fund, Ltd. v. CNET Networks, Inc.,* 954 A.2d 335 (2008); *Levitt Corp. v. Office Depot, Inc.*, 2008 Del. Ch. LEXIS 47 (2008). Although advance notice provisions are permitted under Delaware law, any ambiguity is resolved in favor of stockholders' electoral rights.

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