Navigating the Challenges of Chinese Acquisitions of US Insurers

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Chinese investment in the U.S. insurance industry continued steadily in 2016, notwithstanding efforts by the Chinese government to impose new restrictions on outbound M&A. (See "Regional Focus: Asia.") Examples of such investments included China Minsheng Investment Corp.'s purchase of specialty insurer Sirius International Insurance Group from White Mountains Insurance Group and China Oceanwide Holdings Group's acquisition of life and health insurer Genworth Financial. Meanwhile, the outcome of Anbang Insurance Group's proposed $1.6 billion acquisition of Fidelity & Guaranty Life, announced in November 2015, is pending, with U.S. insurance regulatory approvals still to be obtained. As a result, parties to similar transactions should continue to pay attention to the issues that both private and state-owned Chinese buyers encounter when investing in U.S. insurance companies.

Regulatory Considerations for Chinese Insurance Investors

US State Insurance Approvals

The continued delay of the Fidelity & Guaranty Life transaction underscores a primary concern for sellers and acquirers alike: the ability of Chinese acquirers to obtain timely U.S. regulatory approvals, most notably U.S. state-based "Form A" change-of-control approvals. To obtain consent of any change in control, the acquirer typically must file an application with the U.S. state insurance regulators in the states of domicile of each target insurance company, disclosing, among other information, its background (and that of its executive officers and directors), its financial condition and that of its affiliates, the source and amount of funds it will use for the acquisition, and any plans to change the management and operations of the target insurers. In addition to this information, regulators also will consider potential anti-competitive results of the transaction.

Potential concerns regarding plans to change business operations or management and the acquirer's transparency in connection with its control persons and sources of funding are not unique impositions on Chinese (or other foreign) buyers of U.S. insurance companies. The U.S. private equity industry has encountered similar scrutiny for many years, and various approaches exist to address these concerns, including the use of blocker vehicles to simplify and clarify the ultimate regulatory control structure. In Delaware Life Holdings' purchase of the U.S. annuity business of Sun Life Financial and Athene Holding's acquisition of Aviva USA Corp., the New York State Department of Financial Services imposed a number of conditions on its approvals, including heightened risk-based capital levels, backstop trust accounts and the requirement for prior written approval of material changes to each target insurer's plan of operations.

Restrictions on Chinese Governmental Ownership or Control of Insurers

Nearly 30 U.S. states have decades-old statutes that generally prevent foreign government-owned, operated or controlled insurance companies from being licensed to transact insurance in those states. Many of these statutes were adopted in the mid-1950s due to concerns regarding global socialism and unfair competition. Transactions involving companies in those states should be structured in a way to separate the foreign government from any "control" over the U.S. insurer in order to obtain the necessary approvals. Because a perception (perhaps unjustified) remains that all Chinese investors have some level of governmental ownership, they should be prepared to prove the lack of such ownership or wall off control from such unknown owners and take additional steps beyond Form A approval to comply with U.S. state laws and regulations.

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Committee of Foreign Investment in the United States (CFIUS) Review

Chinese acquirers should be prepared to seek CFIUS approval of acquisitions of insurance companies that are based in, or sell into, the U.S., particularly if the target does business involving the U.S. federal government or its employees. (See "CFIUS and Foreign Investment Reviews in 2017 and Beyond.") In September 2016, following its acquisition by Fosun Group, Ironshore divested its subsidiary Wright USA, which held federal agency employee data, leading many to speculate that CFIUS review prompted the divestiture.

Identifying and Allocating US Regulatory Risk

Conducting Sell-Side Due Diligence of Potential Control Persons

The importance of a potential Chinese acquirer's increased vigilance in sell-side due diligence regarding regulatory preparedness cannot be overstated. U.S. state insurance regulators have not taken an arbitrary approach to reviewing Form A applications from Chinese acquirers; the applications they have approved contain sound business plans and transparent disclosure regarding the acquirer's ownership structure. Sellers should ensure Chinese acquirers are able to complete Form A filings satisfactorily, including by disclosing their "top level" ownership and control, as well as the source of funds for the acquisition. Sellers also need to determine whether any of their businesses could be viewed as implicating national security issues that attract the attention of CFIUS.

Likewise, Chinese investors should understand the scope of expected disclosures and ultimately be prepared to share significant information regarding the composition of their investor base or risk being penalized during a sale process for being perceived as less likely to obtain insurance regulatory approval.

Reviewing Form A Applications, Obtaining Representations or Covenants Regarding Control Structure

Sellers should review completed Form A applications, and the definitive purchase agreement should require the prompt filing of the reviewed applications. Given the due diligence requirements on the acquirer, the preparation of Form A applications should not significantly lengthen the presigning timeline. Moreover, sellers need to consider requiring a Chinese acquirer to represent and warrant both as to the accuracy and completeness of the relevant draft applications and to disclose a list of all potential controlling persons, as was provided by China Minsheng and China Oceanwide. These representations, if negotiated correctly, can be significant tools to bridge perceived acquirer transparency risk in connection with insurance regulatory approvals.

Incorporating Real Remedies in Transaction Agreements

Reverse-termination fees tied to U.S. insurance regulatory approvals are rare, and there are few, if any, examples of such fees in insurance M&A practice. Therefore, it may not be practical or reasonable for a U.S. seller to expect a Chinese buyer to agree to pay a reverse-termination fee if U.S. insurance regulatory approvals are not obtained for any reason.

However, the China Minsheng and China Oceanwide transactions provide two recent examples of transactions where Chinese counterparties have been willing to secure their potential obligations for contractual breach. China Minsheng delivered a $200 million standby letter of credit issued by the Hong Kong branch of a Chinese bank as security for its obligations under its purchase agreement for Sirius. China Oceanwide deposited $210 million into escrow and agreed to pay a $210 million reverse-termination fee to Genworth (approximately 8 percent of the announced transaction value) if the transaction was terminated as a result of failure to obtain PRC, Hong Kong, Macau or Taiwan regulatory approvals or because of material breach of the merger agreement by China Oceanwide.

From a seller's perspective, the willingness of an acquirer to stand behind these representations and to backstop potential breach claims with secured funds should provide a measure of additional confidence that U.S. state regulators' informational requirements will be satisfied. From the acquirer's perspective, complete and correct underlying representations may well limit the risk of not obtaining regulatory approvals.

Divestiture Covenants

Practitioners typically have viewed divestiture covenants as less practical in insurance M&A transactions given the low likelihood (at least outside of the health insurance industry) that a deal will raise competition concerns. However, divestiture and "hold separate" covenants in transactions where the target has insurance (or other) businesses with direct links to the U.S. government or government employees may be beneficial given the likelihood of CFIUS review, particularly with regard to businesses that are less material to the target company.

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Because Chinese counterparties may provide an available source of increased shareholder value, sellers of U.S. insurance companies should continue to view transactions with Chinese investors as viable and potentially attractive, despite the potential for increased execution risk. Well-counseled Chinese investors can be successful acquirers in the U.S. market with the right preparation and understanding of the expectations of state insurance regulators, as well as willingness to share some aspects of regulatory risk with sellers. Despite uncertainty, we expect to continue to see Chinese companies play a meaningful role in U.S. insurance M&A in 2017, and all parties involved should be prepared to implement structures necessary to facilitate successful transactions.