Cooley

Making the Leap: Insurtech to Insurer

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As we have **previously written**, many insurtech companies, and their investors, eventually face the choice of whether to remain an insurance producer (i.e., an insurance agency, brokerage or managing general agent), licensed to sell, negotiate and possibly underwrite insurance, or become a fully licensed insurance company. By becoming a "full-stack" insurance company, the insurtech company can exercise greater control over its business while capturing more of the value chain. In that prior article, we highlighted the significant, though navigable, regulatory issues facing insurtech companies, and their investors, should they decide to make the transition from being a licensed insurance producer to a fully licensed insurance company.

But once an insurtech company, and its investors, decide to take this leap to become a fully licensed insurance company, the company must then decide what path it should take to achieve this goal. There are two primary paths that an insurtech company can take towards owning and operating its own insurance company. They can (1) form a new insurance company or (2) acquire a "shell" insurance company. Although beyond the scope of this article, there are other "intermediate" steps that insurtechs and investors may want to consider prior to owning a full-stack insurer that helps capture more of the value chain. For example, as discussed below, investors may decide to acquire a relatively small percentage of an existing shell insurance company in partnership with other unaffiliated investors and, thus, not be deemed to be a control person of the insurer. Such investors may at a later time, subject to any applicable regulatory approval requirement, acquire greater ownership of the insurer. Alternatively, an insurtech company may decide to form a captive insurer, which has less onerous regulatory requirements but, generally speaking, often limits coverage to certain affiliated business. Further, no US jurisdiction and of the typically used jurisdictions outside the US, only Bermuda, provides a mechanism for a captive to convert to a full insurer.

This article provides an overview of the regulatory considerations that many of our insurtech clients wrestle with in evaluating the business decision of which primary path – form a new insurer or buy a shell insurer – to follow. We also highlight certain regulatory challenges that an insurtech company in particular, including its investors, may confront in navigating this process and how, through careful and strategic planning, to address these challenges.

Forming a new insurance company

In forming a new insurance company, a central decision is the proposed insurer's state of domicile. Although a separate insurance license is required in each state in which a policy is placed, every insurance company has a state of domicile. The domiciliary state's insurance department will serve as the insurer's primary insurance regulator and such state's insurance laws and regulations will dictate key aspects of the company's operations. For example, the insurance laws of an insurer's state of domicile will dictate its entry into intercompany agreements, issuance of dividends and the types and amounts of investments the insurer is permitted to make.

The selection of an insurer's state of domicile depends foremost in which state the company seeks to initially place its policies. However, other factors may also be considered, including the company's primary place of business, its preexisting relationships with regulators and, in particular for insurtech companies, a jurisdiction's receptiveness to innovation. Further, in selecting a state of domicile, it is important to consider the "seasoning" requirements of states in which the insurer eventually plans to operate beyond the domestic state. If imposed, seasoning requirements mandate that an insurance company cannot transact insurance in a nondomestic state unless it has operated satisfactorily in another jurisdiction for a minimum period of time. Although not every state has such requirements and they may be waived in certain circumstance, seasoning requirements have the potential to hamper the ability of an insurance company to scale up quickly. This can be a particularly acute challenge for insurtech companies, where the business model, including the ability to raise additional capital, depends on rapid expansion. Accordingly, these state-by-state requirements should be considered in selecting the proposed insurer's state of domicile so that the insurance company can strategically plan how it will eventually expand into other states.

Once the proposed insurance company's state of domicile is determined, an application for an insurance license must be submitted to the domestic state's insurance department. Although most states accept a uniform application known as the Uniform Certificate of Authority Application, or the UCAA as it is most commonly referred to, many states impose their own additional requirements. The UCAA requires extensive disclosure of the insurer's proposed business plan, including financial projections, ability to maintain statutory capital and surplus requirements and who will be responsible for specific functions at the company (e.g., accounting, underwriting, legal and compliance, etc.). Although many insurtech companies, especially those already conducting business as a producer, may have significant operational capabilities in place, the company needs to consider additional functions that are unique to carriers, such as risk-based capital compliance, statutory accounting and holding company act filings and insurance investment law compliance, among others.

The UCAA also requires extensive financial and personal information disclosure for those entities and individuals who are deemed to "control" the insurer. Under most states' insurance laws, "control" of an insurer is presumed to exist if a person directly or indirectly owns, controls or holds with the power to vote 10% or more of the voting securities of the insurer. When analyzing control, insurance regulators do not merely look at the individual or entity that directly holds the voting securities of the insurer, but rather look all the way up the corporate chain to any individual who beneficially owns, controls or holds with the power to vote 10% of the insurer's voting securities. It is important to note that even if this 10% control threshold is met, the presumption can be rebutted if there are facts demonstrating how a certain entity or individual does not *in fact* control the insurer.

This control test is also important because, in addition to any directors and executive officers of the insurer, all individuals who are deemed to control the insurer will need to submit detailed biographical affidavits to the insurance department as well as undergo background checks, which in some states includes a fingerprinting requirement. Given these extensive disclosure obligations for control persons, investors may want to consider structural mechanisms to potentially rebut a control designation. For example, investors can invest, directly or indirectly, in *non-voting* securities of the insurer with such securities possessing limited rights. Alternatively, investors can invest in an amount of voting securities below the 10% threshold and then later, subject to any applicable regulatory approval requirement, acquire additional voting securities. These options, however, may have consequences that investors will not find desirable (e.g., relinquishing actual control over material aspects of the insurance company).

These financial and personal information disclosure requirements applicable to entities and individuals deemed to control the insurer also apply in the case of acquiring a shell insurance company. Therefore, one path does not necessarily require less disclosure on behalf of a control person than the other.

Acquiring a shell insurance company

In acquiring a shell insurance company, an insurtech company, and its investors, must first assess what is available in the market and whether there is a shell available that holds the requisite licenses. Not only should the shell be licensed in each state in which it will place policies, but such licenses must also be for the specific lines of insurance business at issue. Unlike forming an insurance company anew, by acquiring a shell with preexisting licenses, investors can avoid the seasoning requirements that can often hamper the ability of a new insurer to scale up quickly.

In purchasing a shell insurance company, careful legal and accounting due diligence is essential. Even if an insurance company is advertised as a "shell," it may nevertheless have residual assets or outstanding and contingent liabilities that investors do not want or need. Therefore, investors should consult with legal and accounting professionals to assess the assets and liabilities of the insurer and, based on the findings of such diligence, determine how to structure the acquisition so that it serves investors' needs while complying with insurance regulatory requirements. Further, since much of the value in a shell insurance company is due to the licenses it holds, diligence should also focus on determining that the insurer is properly licensed, such licenses are in good standing, the insurer has satisfactory relationships with state insurance departments and that the insurer is otherwise in compliance with all applicable insurance laws.

As purchasers of an insurance company, investors will need to seek prior approval from the domiciliary state's insurance regulator. This approval process is referred to as a Form A filing. Like the UCAA, the Form A requires extensive financial and personal information disclosure for those entities and individuals who are deemed to control the insurer. The same control analysis pertaining to the UCAA also applies in the Form A context.

As part of the Form A, the proposed acquirers of the insurer will need to provide a detailed business plan that addresses how it will operate going forward, including how it will handle those functions that are unique to carriers, such as risk-based capital compliance, statutory accounting and holding company act filings and insurance investment law compliance, among others. Although the Form A process is onerous and time-consuming, in certain circumstances and jurisdictions it can be a quicker process than the UCAA approval process.

Main takeaways

Once an insurtech, and its investors, decide to take the leap to become a fully licensed insurance company, there are a plethora of regulatory issues to consider before deciding upon what path should be taken to achieve this goal. Although certain regulatory-driven hurdles are unavoidable in pursuing ownership of a fully licensed insurance company, careful and strategic planning can eliminate, or at least mitigate the burden of, some of these hurdles.