Three Potential Landmines for Insurtechs Becoming Full-Stack Insurance Companies

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As funding in the insurtech vertical continues to surge and the current crop of insurtech companies grows and matures, a common dilemma facing the successful companies is whether to move from being just an insurance producer (i.e., an insurance agency, brokerage or managing general agent), licensed to sell, negotiate and possibly underwrite insurance, to becoming a fully licensed insurance company. The high-level business considerations are well known: Decision-makers must balance the rewards of a company's ability to control more aspects of its business and capture more value against the substantial amount of time and capital it will take to form a new insurance company or acquire a shell insurance company. What is less well known to venture capitalists and technology entrepreneurs coming into the insurtech space is how the structure of venture-backed companies can lead to unexpected regulatory problems once an insurtech company decides to pivot from being a licensed insurance producer to a fully licensed insurance company.

Substantial regulatory oversight and delays in closing equity financings

Venture-backed companies are unique in that they raise equity financing in stages from a series of investors at (hopefully) ever-increasing valuations, with a new investor often leading each round of financing. These companies allocate their capital primarily to drive growth over near-term profitability, and thus need to continuously access the capital markets to remain solvent. In each stage a company strives to raise enough money to get to the next meaningful milestone, but not much more since the whole model depends on raising additional funds and higher valuations as the company matures. It's not uncommon for successful companies to come very close to running out of cash prior to a funding round given these dynamics. Usually this is not a problem because an investor can fund the business concurrently with signing the legal documents related to the investment. Though, for insurtechs that have an insurance company structure this may not be possible, and as a result financing may not be available on the desired timeline.

Unlike most technology companies, insurtechs are often set up as licensed insurance producers and are already subject to insurance regulation that varies across all fifty states. However, when an insurtech decides to move from an insurance producer structure to an insurance company structure, regulatory oversight increases significantly. An insurance company has significant minimum capital requirements and typically needs to get proposed premium rates filed and approved by various states. One of the biggest regulatory changes is that the regulatory reach doesn't stop with the insurance company, but extends to its "controlling" investors. Investors that have acquired, or propose to acquire close to, or more than, 10% of the voting securities of an insurtech that is forming or acquiring an insurance company, are often presumed to have a controlling interest in the insurance company and must seek either a "disclaimer of control" or prior approval from regulators for their investment. If a disclaimer of control is not possible, the investor must seek prior approval from the regulators regarding their investment through a process referred to as a Form A filing. The Form A process is onerous and time-consuming – taking several months for the application to be prepared, submitted and reviewed by the applicable regulatory authorities.

While there are structural mechanisms that investors can employ in advance to hopefully avoid being regulated, such as creating non-voting securities for investors to invest in, and there is a process for attempting to rebut the presumption of control through the previously mentioned disclaimer of control filing, none of these options are easy or straightforward. Careful planning is required by both the insurtech and its investors to avoid unexpected and unwanted regulation of the investors.

Draconian disclosure requirements for VC investors

As part of the Form A filing, insurance regulations require any controlling investors to disclose a wide array of financial and personal information that many find to be burdensome and often unacceptable. Venture capital funds with a controlling interest need to disclose their organizational structure, including all of the fund's material investors and detailed financial statements. The managing partners, directors and/or senior officers of the fund will also need to submit biographical affidavits and undergo criminal background checks, which in some states can include submitting fingerprints. These same disclosure requirements would also apply to any investor who holds a controlling interest in the fund itself and is unable to rebut the presumption of control through a disclaimer of control filing. The Form A is technically a public filing, but investors can request that highly-sensitive information, such as the information described above, be kept confidential, and such requests are often granted by the regulator, although confidentiality is not guaranteed.

While it is often fairly easy for a publicly traded insurance company with a corporate venture capital arm to comply with these requirements, non-corporate venture capital funds typically find the Form A process to be far more problematic. Many funds are prohibited from making this type of disclosure under their organizational documents, and others believe that providing their financial statements and disclosing their investors to a regulator puts their trade secrets at risk and places them at a competitive disadvantage with their competitors. Many venture capital investors often find the biographical affidavits, and especially the fingerprinting, to be an unwarranted invasion of privacy. Furthermore, venture capital funds may be unwilling to burden their controlling investors with these same requirements. For investors, becoming subject to regulation and the Form A filing requirements is a material factor in deciding whether to, or how to, invest in an insurance company. VC funds have backed away from potential investment opportunities in the past due to concerns about being subject to Form A disclosure requirements.

Public disclosure of financial results

One of the primary reasons companies stay private is to avoid public disclosure of information about their businesses. Even if a venture capital fund is investing in an insurtech that is currently a producer, careful consideration should be given to structuring that investment in such a way that the venture capital firm will not be subject to regulation if the insurtech later decides to form or acquire an insurance company. Once an insurtech is a regulated insurance company, it is required to make annual and quarterly filings, providing detailed results about its business results, including revenue, loss ratios, surplus ratios, capital ratios and material contracts with affiliates. These filings are similar in scope to the filings required for a publicly traded company. The information is publicly available and can be accessed by a company's competitors and employees, along with potential partners and investors.

Main takeaways

The zeitgeist among insurtechs right now is that in order to truly scale, an insurtech needs to eventually become a "full-stack" insurance company that can own the entire value chain and customer experience. But the insurance regulatory regime was not set up with the needs and interests of technology venture capital funds and their portfolio companies in mind, and careful consideration should be given to how the insurance regulatory regime will affect an insurtech and its investors, prior to and after becoming a licensed insurance company.

*Cooley's **insurtech team** combines a forward-thinking insurance regulatory practice with a preeminent practice representing high-growth technology companies and venture capital funds. We are partnering with entrepreneurs and financiers to help shape new insurance-related innovations within the global insurance regulatory framework.*

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