Debevoise & Plimpton

Debevoise In Depth

Thoughts on Financing and Capital Solutions for Insurance Companies

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With interest rates up significantly since the beginning of 2022 and equity markets having turned negative and volatile with the S&P 500 closing out the first half of 2022 down nearly 21%, insurance company investment and equity portfolios have been and may continue to be adversely affected. Against this negative market backdrop, insurance companies may require additional financing to shore up their regulatory capital, to augment available liquidity until markets stabilize and improve, or more generally to finance the day-to-day operations of the business and pursue other business opportunities. Ultimately, the most appropriate and optimal means of raising necessary additional capital depends on a range of factors including the then-current composition of the company's capital structure, the intended use of proceeds, and regulatory and rating agency considerations. At a basic level, straight equity financing is optimal from a regulatory capital perspective while straight debt financing is generally less expensive than equity financing and non-dilutive. Sitting between the pure equity and debt ends of the financing spectrum are "hybrid" securities (e.g., debt capital that is structured such that it qualifies for rating agency equity capital credit). In the following brief note, we have summarized a number of the common forms of debt and equity financing utilized by insurance companies in connection with capital raising activities.

Surplus Notes

Surplus notes are instruments unique to U.S.-domiciled insurance companies. Over $7 billion in aggregate principal amount of surplus notes were issued in 2020 and 2021. A surplus note is similar to a typical "vanilla" senior debt security other than in one important respect: regulatory approval is required prior to the issuance of or payment on a surplus note. In addition, to be treated as a surplus note, the instrument must be expressly subordinated to all policyholder, beneficiary and creditor claims. Key features of surplus notes include:

Regulatory Approval. Both the initial issuance of a surplus note and any payment of interest or principal on a surplus note must be approved by the relevant state insurance regulator. Payments on the notes may be approved by the regulator only if it deems surplus to be sufficient to safely do so. Further, the form of the agreement under which a surplus note is issued (*e.g.*, a fiscal agency agreement) and the form of the note itself must be approved by the relevant state insurance regulator.

Covenants and Defaults. Surplus notes typically have few, if any, covenants; and the failure to obtain regulatory approval for the payment of interest or principal is not typically a default or event of default.

Maturity. The maturity of a surplus note can vary from a relatively short-term tenor of five to 10 years to a tenor as long as 50 to 60 years.

Optional Redemption. An optional redemption feature is common, with the notes optionally redeemable at a make-whole prior to a par call date, which is typically one to six months prior to maturity, depending on tenor. Surplus notes are also regularly structured to include a tax event optional redemption at par. This type of redemption provision typically dictates that a tax event occurs when there is a change in the tax law such that there is more than an insubstantial increase in the risk that interest payable on the surplus notes will not be deductible for U.S. federal income tax purposes.

Offering Document/Marketing. Insurance companies commonly issue surplus notes to investors in a Rule 144A/Regulation S marketed offering or in a one-off privately negotiated transaction with institutional investors. Marketed offerings of surplus notes require the preparation of an offering memorandum that may include U.S. GAAP or statutory financial statements. The associated marketing effort may include a formal “roadshow” by senior management to investors and may include a pre-marketing “wall-crossing” process whereby institutional investors are subject to selective discussions under cover of confidentiality for a limited period of time to gauge potential interest. Surplus notes are also frequently issued in a directly negotiated private placement with one or more institutional investors and are regularly used by insurance companies to move capital internally, including between an unregulated holding company and a regulated insurance subsidiary.

Regulatory Capital. From a regulatory capital perspective, surplus notes are treated as surplus, or equity, and are included as part of the insurance company’s total adjusted capital under risk-based capital (“RBC”) calculations. Surplus notes are similarly treated as surplus or equity for statutory accounting purposes and the proceeds thereof are treated as assets of the insurer. By contrast, under U.S. GAAP, these instruments are treated as debt and reported as a liability on the insurer’s balance sheet. Surplus notes are also eligible to be treated as regulatory capital under the capital adequacy requirements of the Board of Governors of the Federal Reserve System, if applicable. Surplus notes issued by an insurer to an upstream parent will ordinarily qualify for capital treatment even when the parent uses proceeds from a third-party financing to purchase the note.

Tax. While surplus notes are treated as equity from a regulatory capital perspective, they may be treated as debt for tax purposes (despite the requirement of regulator approval for payments), if they possess a sufficiently debt-like character under case law and Internal Revenue Service ("IRS") guidance. Debt treatment typically is desirable, as it allows for tax deductions on interest payments and generally permits interest payments to non-U.S. holders without withholding. A key distinction looks to whether the noteholder reasonably expects payment from the cash flows of the business as a lender would, or instead is taking on the entrepreneurial risk of the business in order to be repaid, as an equityholder would. While very long maturity dates can put pressure on this analysis, issuers have treated surplus notes with maturities as long as fifty or sixty years as debt where the maturities were tailored to the expected liability profile of the business and repayment expectations were considered strong.

Senior Debt Securities

Senior debt securities are commonly unsecured and issued by a top-tier holding company in an insurance company group structure. The proceeds from these types of issuances are generally available for "down-streaming" (including by means of an internal surplus note) to operating companies with operational or capital needs. While these securities will have a priority in the case of an issuer bankruptcy event over holders of the issuer's equity or more junior debt securities, these securities will be structurally subordinated to obligations (including policyholder obligations) of the company's insurance operating companies.[1] Key features of senior notes include:

Covenants and Defaults. Like surplus notes, senior debt securities typically include few, if any, restrictive covenants and basic default events.

Maturity. The maturity of senior debt securities can vary from relatively short-term tenors of 3, 5 or 7 years to longer term tenors such as 10, 20 or 30 years.

Optional Redemption. An optional redemption feature is common, with the notes optionally redeemable at a make-whole prior to a par call date (typically one to six months prior to maturity depending on tenor).

Offering Document/Marketing. Senior debt securities are commonly issued to investors in a Rule 144A/Regulation S private offering or through an SEC-registered offering. A Rule 144A/Regulation S private offering for public companies requires the preparation of an offering memorandum with U.S. GAAP financial statements, or if issued by a

[1] Even if issued by an insurance operating company, senior debt securities will commonly have a lower priority in the case of an issuer bankruptcy than policyholder obligations under applicable state insurance law.

regulated insurance company, statutory financial statements. An offering registered with the Securities and Exchange Commission ("SEC") must be effectuated under an appropriate registration statement form (*e.g.*, a Form S-1 for a new or unseasoned registrant or a Form S-3 for a more seasoned issuer), with each such form setting forth requirements regarding qualitative and financial disclosure to be included in the relevant prospectus and the extent to which such disclosure may be incorporated by reference from the insurer's other SEC filings (if any). Senior notes issued under Rule 144A/Regulation S by an insurance holding company that is an SEC registrant may require the registrant to ultimately provide investors with SEC registered notes in exchange for such previously privately placed notes via an "A/B" exchange offer. As is the case with the sale of surplus notes, the marketing process associated with the sale of senior notes may include an associated "roadshow" and "wall-crossing" process.

Regulatory Capital Treatment. From a regulatory capital perspective, senior debt securities do not generally receive any equity credit for regulatory or rating agency capital purposes.

Subordinated Debt Securities

"Vanilla" subordinated debt securities have similar attributes to senior debt securities other than the fact that by definition such securities sit behind senior debt securities in the case of an issuer bankruptcy event (and as such typically carry a higher interest rate). By virtue of this junior position, subordinated debt securities are commonly referred to as junior subordinated debt securities. Junior subordinated debt securities may also carry with them additional features that make them more equity-like and, as such, earn equity credit from rating agencies. These types of equity-like junior subordinated debt securities are commonly referred to as "hybrid notes" and have been a mainstay in the insurance company financing arsenal. Key features of typical "hybrid notes" include:

Interest Rate. These instruments typically have an interest rate that resets every five or 10 years based on an applicable benchmark (*e.g.*, the applicable U.S. treasury rate at the reset time) plus a pre-determined margin.

Interest Deferral. This feature goes a long way to giving a subordinated debt security an equity-like flavor and commonly permits the issuer to defer the payment of interest for one or more consecutive interest periods that do not exceed five years for any single deferral period. The *quid pro quo* for the deferral feature is covenant restrictions that limit the issuer's ability to pay dividends or repurchase its capital stock or make payments on any *pari passu* or junior debt securities during a deferral period.

Optional Redemption. An issuer's ability to redeem outstanding hybrid notes is typically limited, with the optional redemption feature coming in two primary flavors. The first permits the issuer to redeem the notes at par during the three months prior to an interest reset date or redeem at a make-whole at any other time. The second permits the issuer to redeem the notes at par on any interest payment date (*i.e.*, semi-annually) beginning with the first interest reset date and redeem at a make-whole at any time prior to the first interest reset date. The issuer will also typically have the ability to redeem outstanding notes following the occurrence of certain events that typically include a tax event, a rating agency event and a regulatory capital event.

- A "tax event" is commonly defined to generally occur if there is a change in applicable tax law such that there is more than an insubstantial increase in the risk that interest payable on the notes will not be deductible for U.S. federal income tax purposes.

- A "rating agency event" is commonly defined to generally occur if there is a shortening of the length of time that the notes are assigned a particular level of equity credit from the length of time the notes would have been assigned that level of equity credit initially or the amount of equity credit assigned is lowered.

- A "regulatory capital event" is generally defined to occur if the notes no longer qualify as capital under applicable capital adequacy guidelines.

Upon the occurrence of a tax event or a regulatory capital event, the issuer will typically be permitted to redeem the notes at par, and, in the case of a rating agency event, the issuer will typically be permitted to redeem the notes at a premium to par.

Any ability to optionally redeem some forms of hybrid notes, particularly those that qualify for greater equity credit and are issued by insurers that are subject to particular solvency regimes (*e.g.*, Solvency II), may be subject to regulatory approval and/or related replacement capital obligations.

Offering Document/Marketing. The offering and marketing process for the sale of hybrid notes is analogous to the process associated with the offer and sale of senior notes described above.

Rating Agency Treatment. The extent of equity credit afforded to an insurer by a rating agency in connection with the issuance of hybrid notes is highly dependent upon the exact terms of the notes. At a very basic level, the extent of equity credit granted to any particular instrument is a function of:

- the "permanence" of the instrument (*i.e.*, its redemption structure);

- the provisions governing the "servicing" of interest and principal payments (*e.g.*, does the instrument require interest to be paid currently, may the issuer defer payment of interest and on what terms and is payment of principal subject to regulatory approval or the satisfaction of other conditions); and

- the extent of the instrument's "subordination."

Hybrid notes typically receive equity credit from rating agencies up to a specified percentage of the company's total capital, which credit will depend upon the specific terms of the hybrid notes and the particular rating agency's criteria. This benefit can help an insurer manage its overall debt-to-capital ratio and, to the extent that an insurer is subject to a restrictive covenant that limits its ability to incur senior indebtedness (*e.g.*, a consolidated indebtedness to total capitalization financial covenant), hybrid notes are typically not included in the required calculation of consolidated indebtedness to the extent of the equity credit afforded to such notes by the rating agencies. As a result, hybrid notes provide an insurer with additional flexibility to finance its business without incurring the full impact on its ratings or financial covenants that senior or vanilla subordinated debt would have.

Tax. While subordination can be an unhelpful factor in a tax debt/equity analysis, hybrid notes may still be structured to be treated as debt if, as with surplus notes, they possess sufficiently debt-like features overall (an investment grade rating is particularly helpful). While some instruments that permit deferral of cash interest payments (such as "PIK" notes) or have uncertain payment schedules can require holders to include interest income prior to the receipt of cash under the "original issue discount" or "contingent payment debt instrument" rules, the interest deferral feature of a hybrid note generally may be ignored at issuance if the likelihood of actually exercising the deferral right is seen as remote.

Pre-capitalized Trust Securities (or "PCAPs")

PCAPs are a capital markets-based structure that functions like a contingent capital facility with some key features analogous to those found in a revolving credit facility, but PCAPs can be much longer dated with minimal counterparty risk. These key features include:

General Structure. Generally, in a PCAPs transaction, the sponsoring company creates a new Delaware statutory trust or other special purpose vehicle. That trust issues trust securities to qualified institutional buyers in a Rule 144A/Regulation S offering. The proceeds from the issuance of the trust securities are invested by the trust in a portfolio of principal and interest strips of U.S. Treasury securities (the "Eligible Assets") that, together with the facility fee described below, matches the expected payments on the trust securities.

Concurrently with the issuance of the trust securities, the trust enters into a facility agreement with the company. The facility agreement provides the company with an issuance right (the "Company Issuance Right") that permits the company, at its option, to issue senior notes to the trust and require the trust to purchase such senior notes with an equivalent amount of the Eligible Assets. The company is required to exercise the Company Issuance Right in full upon certain automatic or mandatory triggers, including events of bankruptcy, certain payment defaults, or if the company's consolidated net worth falls below a threshold amount. In return for the Company Issuance Right, the company pays the trust a facility fee. The facility fee together with the income from the Eligible Assets is equal to the coupon on the trust securities.

Ratings. The trust securities are typically rated in line with the company's senior notes ratings and are designed to mimic an investment in the company's senior notes, providing investors a risk profile equivalent to a direct investment in the company's senior debt.

Exercise of PCAPs Facility. If the company wants to exercise the Company Issuance Right and receive the Eligible Assets, it delivers a notice to the trust. Assuming full exercise of the Company Issuance Right, the trust's sole asset will be the company's senior notes. Most PCAPs facilities permit the company to exercise the Company Issuance Right in part, in which case the company would issue a portion of the contractually agreed maximum aggregate principal amount of senior notes to the trust and receive the equivalent amount of Eligible Assets. The trust's assets would then comprise the remaining Eligible Asset and the senior notes so issued. The facility fee on the unissued senior notes, the coupon on the senior notes and the income from the remaining Eligible Assets would provide sufficient funds to pay the coupon on the trust securities.

Leverage Neutral. One of the key benefits of PCAPs is that PCAPs are leverage neutral day one and are generally viewed positively by rating agencies. Until the senior notes are issued to the trust, the PCAPs are not reflected on the company's balance sheet and not included in the company's financial leverage. The off-balance sheet nature of the PCAPs structure enables the company to proactively prepare for contingencies, while ensuring the company does not advertise an artificially inflated leverage level or breach any leverage-related financial covenants prior to issuance. Rating agencies generally view PCAPs as a credit positive because it improves the company's access to liquidity, especially in times of stress.

Refreshable. The PCAPs facility is also refreshable, which allows the company to repurchase the senior notes with Eligible Assets and then later reissue the senior notes in return for the Eligible Assets.

Other Structural Features. There are a number of structural features designed to provide the company with additional flexibility and optionality, including as a backstop to letter of credit facilities. *See* our article "*The Financing Flexibility of P-Caps*" *available* here for more detail on the structure and available options.

Tax. PCAPs facilities are complex arrangements, and raise technical questions as to the correct characterization of the relevant payments for tax purposes. There are multiple paths to concluding the company is entitled to a current tax deduction for its payments, which typically is the main focus in these arrangements. Assuming the relevant criteria are met, the company should obtain a net deduction equal to the spread between the coupon on the senior notes and the return on the Eligible Assets (an amount equal to the pre-draw Facility Fee) both before and after the facility is drawn.

Funding Agreement-Backed Notes

Funding agreement-backed notes ("FABNs"), like surplus notes, are another financing option unique to insurance company issuers. FABNs are typically issued through programs that are designed to accommodate periodic or regular issuances.

General Structure. In this structure, a special purpose vehicle (an "SPV"), typically a Delaware statutory trust, issues multiple series of notes to institutional investors in Rule 144A/Regulation S offerings or to a single institutional buyer in a private placement. The SPV uses the proceeds from the sale of each series of notes to purchase one or more funding agreements from the insurance company issuer (funding agreements are akin to guaranteed investment contracts or "GICs"). The insurance company issuer deposits the proceeds from the sale of the funding agreement into its general account or a separate account to be invested in other assets. The insurance company issuer then earns the spread differential between the cost of its obligations under the funding agreement and the yield on its invested assets. The funding agreement is pledged and collaterally assigned to the indenture trustee to secure the SPV's obligations under the relevant series of notes. The notes may be listed on a foreign exchange (*e.g.*, Euronext Dublin).

Flexibility. FABN programs are flexible and can be structured to accommodate issuance of notes with fixed or floating rates of interest, with interest rates tied to nontraditional assets, in multiple currencies, with various redemption/put options and other customized features. It also allows for reverse inquiries from institutional investors or corporations with the funding agreement and related notes customized to a specific investor request. Once a program is established, takedowns can be accomplished quickly if the program is kept updated, including with respect to disclosure and due diligence.

Benefits. The benefit of the FABN structure is that it functionally allows the insurance company issuer to "convert" a non-tradable insurance product into marketable and more liquid securities with a lower funding cost than senior notes due to the higher priority of the funding agreement in insolvency. In addition, each issuance is from a separate series of the SPV, which is considered to be legally distinct for insolvency purposes. Investors receive the "pass-through" benefits of an insurance product, namely higher priority in a rehabilitation or liquidation as a policyholder than they would have as a holder of senior notes. The ratings on the notes typically correspond to the underlying insurance company issuer's financial strength rating.

Tax. Although the funding agreement is regulated as an insurance product, it generally is treated as debt for tax purposes, similar to the instruments described above. Thus, no reserve deduction should be expected upon sale of the funding agreement, but no premium income is recognized on receipt of the proceeds, and the issuer generally should obtain deductions equal to the FABN interest.

Depositary Shares

A form of equity financing frequently used by insurance company issuers is depositary shares that represent a fractional interest in a share of preferred stock issued by the company and deposited with the depositary. The depositary shares pass through the terms of the underlying preferred stock to investors on a fractional basis. From 2017 through 2021, over $11 billion of depositary shares were issued by insurance companies.

Dividends. The underlying shares of preferred stock are typically perpetual and pay dividends quarterly. The dividends are not mandatory and noncumulative. If dividends have not been paid for the prior dividend period, the company may not pay dividends on, or redeem or repurchase, its common stock (or other junior stock).

Voting Rights. The holder of the shares of preferred stock has no voting rights except with respect to changes in the terms of the securities and for the election of two additional members of the company's board of directors if dividends have not been declared and paid in an aggregate amount equal to full dividends for at least six quarterly dividend periods, whether or not consecutive. This latter voting right is required by the stock exchanges for listed preferred stock. To the extent any vote is required, the depositary will vote whole shares representing the number of fractional votes it received from the holders of the depositary shares.

Optional Redemption. The company may optionally redeem the shares of preferred stock at any time after a specified initial no-call period, *e.g.*, five years, at the liquidation preference plus accrued and unpaid dividends. During that initial no-call period, the company also has the right to redeem the shares of preferred stock in the event of a rating agency event (at a premium to par) or regulatory capital event (at par). A "rating agency event" occurs when there is a shortening of the length of time that the shares of preferred stock are assigned a particular level of equity credit from the length of time the shares of preferred stock would have been assigned that equity credit initially or the amount of equity credit is lowered. A "regulatory capital event" occurs when the shares of preferred stock no longer qualify as capital under applicable capital adequacy guidelines. A corresponding amount of depositary shares are redeemed with the proceeds of the redemption of the shares of preferred stock.

Offering Document/Marketing. These transactions are typically SEC-registered transactions that are offered and sold to retail and institutional investors and listed on a stock exchange. As a result, the issuer will need to prepare and file a prospectus supplement with the SEC and typically participate in marketing efforts.

Board of Director Action. Depositary share issuances require the establishment of an underlying series of preferred stock, which requires action by the issuer's board of directors to adopt a new certificate of designations (or the equivalent in the issuer's jurisdiction) with the terms of the preferred stock. Action by the board of directors or a duly authorized committee thereof will be required for the declaration of dividends each quarter as well.

Benefits of a Fractional Interest. The benefit of issuing a fractional interest in a share of preferred stock is that it allows the company to issue a much smaller number of shares of preferred stock, of which a limited number have typically been authorized in the company's certificate of incorporation and increasing the authorized number would require shareholder approval. It also makes the securities more accessible to retail investors given the lower par value for the depositary shares, typically $25, rather than the $25,000 stated amount for the underlying preferred shares.

PIPEs Transactions

A private investment in public equity, or PIPE, is a transaction that is more frequently seen during times of economic stress as traditional financing markets may not be available, but even in the best of times PIPEs may provide an attractive source of financing.

General Form. These bespoke transactions can take many forms, with preferred stock instruments being the most typical form of PIPE investments. The exact form of any preferred stock instrument will vary, with some taking the form of convertible preferred, which offers equity upside while providing downside protection, and with others structured to behave more like straight debt, which offers a higher return than debt at the cost of greater risk due to the instrument's lower place in the capital structure and weaker covenant protections. PIPEs may also take the form of common stock, convertible notes, warrants or any combination of the foregoing instruments.

Key Terms. Negotiations of PIPEs typically focus around the dividend or coupon rate, the terms on which the preferred stock converts into common stock, maturity date, issuer redemption rights, protective covenants, governance and shareholder rights and obligations, including transfer restrictions, registration rights and standstills.

Governance. PIPE transactions are typically structured as minority investments. In most cases, an equity stake of around 10% is required to receive the right to designate one or more board members. Above 10%, the number of board designees depends upon the specifics of the particular transaction, the envisioned relationship between the investor and the issuer and, in many cases, regulatory considerations. The investor's right to continue to designate representative(s) to the issuer's board following the initial issuance is typically contingent upon the size of the investor's ownership stake, measured as a percentage of the outstanding equity or as a percentage of the initial purchase. The committee membership of board designees is also subject to negotiation. Typically, where the investor has the right to designate one representative, the representative is given the right to sit on a specified committee and granted observer rights for other committees. As the number of investor designees increases, investor designees are typically given proportional representation on all committees, subject to applicable legal and governance requirements.

Shareholder Approval. A key question to be answered in connection with structuring a PIPE transaction is whether shareholder approval is needed. The requirements differ slightly depending on whether the issuer is listed on the NYSE or Nasdaq, and we discuss each in turn below.

- For NYSE-listed companies, shareholder approval is required in three main circumstances: (1) the issuance of common stock, or securities convertible into or exercisable for common stock (collectively, "Common Securities"), equal to or greater than 20% of a company's (pre-issuance) common stock or voting power requires a shareholder vote unless (A) a minimum price requirement is fulfilled and

(B) no purchaser or group of related purchasers acquires more than 5% of the company's common stock or voting power; (2) whenever a listed company issues Common Securities to certain related parties, including a "substantial security holder" (generally, a holder of 5% or more of outstanding common stock or voting power) where the securities to be issued exceed 1% of the issuer's outstanding common stock or voting power prior to the issuance, unless the issuance to a substantial security holder meets an "at or above market" minimum price requirement, in which case, shareholder approval is required only if the Common Securities to be issued exceed 5% of the issuer's outstanding common stock or voting power; and (3) issuances resulting in a change of control of the company.

- For Nasdaq-listed companies, the issuance of Common Securities equal to or greater than 20% of a company's (pre-issuance) common stock or voting power requires a shareholder vote unless a minimum price requirement is fulfilled, with the minimum price defined as the lower of (a) the closing price immediately preceding the signing of the binding agreement and (b) the average closing price of the common stock for the five trading days immediately preceding the signing of the binding agreement. Shareholder approval is also required for change of control transactions, with Nasdaq presuming a change of control where a shareholder acquires 20% of the company's outstanding common stock, calculated on a post-transaction basis.

Exceptions may be made to the shareholder approval policy for NYSE-listed companies upon application to the NYSE when (1) the delay in securing shareholder approval would seriously jeopardize the financial viability of the company and (2) reliance by the company on this exception is expressly approved by the audit committee of the board of directors. Similarly, an exception to the shareholder approval policy for Nasdaq-listed companies is available upon application to Nasdaq and a showing that the delay in obtaining shareholder approval would seriously jeopardize the financial viability of the company and the company has received express approval to rely on this exception from its audit committee or a comparable body of its board of directors comprised solely of independent, disinterested directors.

Structuring Alternatives. Because PIPEs are sometimes a mechanism for an existing shareholder to provide financing or the investor will be receiving more than 20% of the Company's common stock or voting power, the shareholder approval requirement may be a barrier around which parties need to structure. PIPE investors will frequently agree to cap their conversion rights at 19.9% until shareholder approval is obtained. Alternatively, investors sometimes structure their investment in two steps: a 19.9% tranche that can close immediately and the balance contingent upon obtaining shareholder approval. In either case, the coupon will often ratchet up and other rights might come into play if the acquisition does not get approved by shareholders after a period of time.

Insurance Regulatory Approval. For an insurance company, a fundamental question is whether state insurance regulatory approval will be required to approve a new controlling person. Generally speaking, an investment in 10% or more of the voting securities of the insurance company creates a presumption of control. The New York State Department of Financial Services released a Circular Letter in April 2022 clarifying its view that all the facts and circumstances should be considered when determining whether a particular party controls or will control an insurance company, not just the percentage ownership of voting securities. *See* our article "*New York DFS Issues Guidance Regarding Transactions with New York Insurers with Broad View of Potential Control Issues*" here for more discussion on the control determination. While the determination of control (or a controlling influence) depends on all the facts and circumstances, many parties will limit their investment to 9.9% of the voting securities of the issuer in order to avoid a presumption of control, or divide the transaction into multiple tranches, with the acquisition of up to 9.9% of the issuer occurring initially, and some greater percentage occurring only once state insurance regulatory approvals are received (which can take six to nine months depending on the state). Another approach is to have the investor acquire two different classes of common stock—up to 9.9% of high vote or one vote common stock and the remaining economic interest being acquired in low vote or nonvoting common stock to keep the investor's voting power below 9.9% and avoid the presumption of control.

Tax. Tax structuring relating to PIPEs typically focuses on whether (and in what circumstances) holders could be treated as receiving dividends for tax purposes prior to receipt of cash—particularly undesirable if the instrument could have non-U.S. holders that are subject to withholding tax on dividends. This entails a close analysis of the features of the instrument, including terms of entitlement to dividend payments, the potential for dividends on or redemptions of common or other preferred stock, and entitlements on conversion to common equity or upon liquidation of the issuer. If various tax rules are successfully navigated, redemption of the PIPE may qualify for capital gains treatment, which may be taxed at preferential rates for U.S. individuals and is not subject to withholding tax for non-U.S. holders. Conversion of preferred equity to common equity generally is treated as a nontaxable transaction for the issuer and holders (except with respect to dividend arrearages).

Final Thoughts

Insurance companies have a range of financing options available to them that may be used for one or more purposes, including to provide financing for ordinary or extraordinary business needs, increase regulatory capital, provide liquidity generally and manage ratings and leverage ratios. As to what type of financing is appropriate, the relevant questions are what type(s) of financing satisfies an insurance company's particular need(s) and at what cost? We are available to discuss these and any other questions related to the summary thoughts presented in this note.

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Please do not hesitate to contact us with any questions.

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