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Recent Amendments to the Pennsylvania Insurance Holding Company Act Changes Affecting Corporate Governance and Intercompany Transactions and Agreements

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Pennsylvania's Insurance Holding Company Act (IHCA) was recently amended by Act 136, which was signed into law on July 5, 2012. Act 136 makes a number of changes to the IHCA, including imposing new corporate governance requirements and processes and expanding the Pennsylvania Insurance Department's authority to examine affiliates of an insurer. Additionally, Act 136 specifies new information that must be included in an insurer's registration statement filing (Form B filings), newly mandates prior regulatory approval of certain transactions and agreements between insurers and their affiliates (Form D filings), and newly requires notice to the Insurance Department following the termination of certain intercompany agreements. The changes made by Act 136 affecting corporate governance and transactions and agreements between members of an insurance holding company system are addressed in this Alert. Other aspects of Act 136 are discussed in other Alerts we have issued.

Composition of the Board of Directors

Under the current IHCA, not less than $^{1}/_{3}$ of the directors of a domestic insurer,[1] and not less than $^{1}/_{3}$ of the members of each committee of the board, must be independent directors.[2] Additionally, domestic insurers must establish a committee to perform the functions of an audit, and nominating and compensation committees. Only independent directors may serve on the committees that perform these functions.

Prior to Act 136, an insurer was exempt from these independent director standards if the insurer's controlling person was either an insurer or another business entity, and if the controlling person had a board and committees that satisfied the independent director requirements of the IHCA. Now, under Act 136, an insurer is exempt from these standards only if the controlling person is an insurer, a publicly held corporation (as opposed to any type of business entity), a mutual holding company, or an attorney-in-fact for a reciprocal exchange, and if the controlling person has a board and committees that satisfies the independent director requirements of the IHCA. Insurers that previously have relied upon the composition of the board and committees of their parent company to satisfy the requirements of the IHCA should ensure the composition of their board and committees remains appropriate after the changes enacted by Act 136.

New Form B

Currently, the IHCA requires a domestic insurer that is a member of an insurance holding company system file with the Insurance Department an annual registration statement, commonly known as a Form B filing. The Form B filing must contain certain prescribed information, such as loans by the insurer to an affiliate; loans to the insurer from an affiliate; purchases, sales or exchanges of assets between the insurer and an affiliate; intercompany management, service, cost-sharing, reinsurance and consolidated tax allocation agreements; and intercompany transactions that are not in the ordinary course of business.

Under Act 136, an insurer must now submit its Form B on a form and in a format as prescribed by the National Association of Insurance Commissioners (NAIC). Previously, Pennsylvania had adopted its own Form B. However, on and after the effective date of Act 136 (September 3, 2012), insurers will be required to make its Form B filings utilizing the Form B promulgated by the NAIC.

Of note, both the Pennsylvania Form B and the current NAIC Form B[3] require an insurer furnish a chart listing the identities of and interrelationships among all affiliates within the insurance holding company system. However, the Pennsylvania Form B does not require an insurer list an affiliate if the affiliate's total assets are less than ½ of 1 percent (0.5 percent) of the total assets

1 Only domestic insurers that are members of an insurance holding company system are subject to the requirements discussed in this Alert.

2 The IHCA contains standards defining the qualifications for an independent director.

3 The most current version of the NAIC Form B was promulgated in 2010.

of an ultimate controlling person, unless the affiliate has assets in excess of $5 million. The NAIC Form B does not contain such an exemption. Therefore, it appears insurers will need to list all of its affiliates on its Form B filings including, for example, non-operational affiliates with di minimis assets.

New Form B Statement Regarding Governance and Internal Control

Pursuant to Act 136, insurers must newly include in their annual Form B filings a statement that the insurer's board of directors oversees corporate governance and internal controls. Additionally, insurers must include a statement that the insurer's officers or senior management have approved and implemented, and continue to maintain and monitor, corporate governance and internal control procedures. While this requirement may not expand the legal duties currently imposed on directors and officers, it will provide the Insurance Department with a representation from the insurer that such oversight and controls are, in fact, operational.

Special focus on this requirement appears warranted for insurance companies with overlapping boards or who share management with a parent company. For example, if the directors generally concentrate on significant corporate-wide issues confronting the insurance holding company system as a whole, the board should ensure that its oversight of the governance and internal controls of the insurer is not inappropriately circumscribed or limited with respect to issues specific to the insurer. Similarly, if management is shared within the insurance holding company system, the officers should ensure corporate-wide issues or problems do not eclipse the implementation of appropriate governance and internal control procedures at the insurance company level.

Parental and Affiliate Financial Statements

Under Act 136, the Insurance Department may request, and the insurer must include in its annual Form B, financial statements of the insurance holding company system including affiliates. Financial statements filed with the SEC may satisfy this requirement.

Examination of Affiliates and their Books and Records

Under Act 136, the Insurance Department is authorized to order a domestic insurer to produce books and records in the possession of its affiliates, if such materials are reasonably necessary to ascertain the financial condition of the insurer or to determine whether there is compliance with the IHCA. Additionally, the Insurance Department may order an insurer to produce information that is not in the possession of the insurer if the insurer can obtain access to the information pursuant to a contractual relationship, statutory obligation or other method.[4] If the insurer cannot obtain the information requested by the Insurance Department, the insurer must explain the reason(s) the information is not obtainable and identify the person that possesses the requested information.

If the insurer fails to comply with an order issued by the Insurance Department to produce books and records, the Insurance Department is authorized by Act 136 to examine the insurer's affiliates to obtain the information.[5] The department also has the power to issue subpoenas and examine, under oath, any person as to any matter pertinent to determining the insurer's financial condition or compliance with the IHCA. The costs for any such examination, including expenses incurred by the Insurance Department in engaging attorneys, actuaries, accountants or other experts, may be assessed upon the insurer.

Form D Filings

Under the current IHCA, insurers must provide at least 30-days advance notice to the Insurance Department regarding certain intercompany transactions and may effectuate the transaction if the Insurance Department has not disapproved the filing within that 30-day period. These filings are commonly known as Form D filings.

Act 136 does not mandate the use of a NAIC form for Form D filings, unlike the change made with respect to Form B, discussed previously. Accordingly, it appears insurers may utilize the Form D form previously adopted by the Insurance Department, or any updated version of the form that may be adopted by the Insurance Department in the future.

Under the current IHCA, if the materiality threshold is met, insurers must submit a Form D filing if the insurer proposes to enter into a sale, purchase, exchange, loan, extension of credit, investment or pledge of assets with a member of the insurance holding company system. A Form D is also required if the insurer will receive assets from an affiliate as a contribution to the insurer's surplus, if the transaction meets the materiality threshold. Act 136 has changed the materiality threshold applicable to these Form D filings. Now, the materiality threshold

4 The Insurance Department is also authorized to obtain documents from the insurer or its affiliates if the documents provide a basis for, or otherwise clarify, the role of a regulatory official to act as the group supervisor for certain international insurance groups.

5 The statute also specifies certain administrative sanctions and civil penalties for noncompliance.

is met when the value of the transaction is 3 percent[6] or more of the insurer's admitted assets or 25 percent of the insurer's policyholder surplus,[7] whichever is less.[8]

Additionally, under Act 136, intercompany pooling agreements are now expressly subject to the Form D filing requirement, without regard to any materiality threshold. Other types of intercompany reinsurance agreements also remain subject to the Form D filing requirements, provided the materiality threshold is met, which threshold was not changed under Act 136. A Form D filing is required for non-pooling intercompany reinsurance agreements if the reinsurance premium will equal or exceed 5 percent of the insurer's policyholder surplus as of the previous December 31. A Form D filing is also required for non-pooling intercompany reinsurance agreements if the assets required to fund the transaction, or the change in the insurer's liabilities, will equal or exceed 25 percent of the insurer's policyholder surplus.[9] However, Act 136 newly requires that the reinsurance premium, transfer of assets and change in liabilities be projected for each of the next three 12-month periods. Previously, the IHCA did not prescribe an explicit time frame for measuring the materiality triggers.

Act 136 also newly subjects intercompany management, service, tax allocation and cost-sharing arrangements to the Form D filing requirement. Additionally, intercompany guarantees are now subject to the Form D filing requirements.[10] There is no materiality threshold applicable to these types of agreements.[11]

Act 136 did not change the standards applicable to "material transaction" Form D filings. See 40 P.S. 991.1405(a)(2)(iv) and 31 Pa.Code § 27.1 *et seq*.

6 Previously, under the IHCA, this materiality standard was 5 percent.

7 Admitted assets and policyholder surplus are calculated as of the previous December 31.

8 Loans and extensions of credit to non-affiliates, for the ultimate benefit of an affiliate of the insurer, are also subject to these same standards.

9 Reinsurance agreements with non-affiliates are also subject to the same standards, if assets will ultimately be transferred to an affiliate of the insurer.

10 This new standard can be traced to the Insurance Department's examination of the AIG companies in 2010, during which it was learned that the insurers had exposure to nearly $240 billion in contingent liabilities under various intercompany policyholder guarantees.

11 It must be noted that guarantees are subject to a Form D filing under the current IHCA, subject to a materiality threshold. See 40 P.S. § 991.1405(a)(2)(i). Act 136 did not delete guarantees from that subsection when the General Assembly added guarantees to the new filing requirements at 40 P.S. 991.1405§ (a)(2)(v), which new section does not contain a materiality threshold. Therefore, guarantees are mentioned in two different, and conflicting, provisions under Section 1405. Under statutory interpretation principles, it is likely that the newly added requirement at 40 P.S. 991.1405§ (a)(2)(v) will be viewed as the applicable standard, requiring that guarantees be filed without regard to a materiality threshold.

Amendments to Intercompany Agreements

Act 136 requires a Form D filing for an amendment or modification of an agreement, if the agreement was previously filed under a Form D filing. Therefore, insurers will need to make a Form D filing upon an amendment to an existing agreement relating to a sale, purchase, exchange, loan, extension of credit, investment or pledge of assets, and to existing intercompany reinsurance agreements (except pooling agreements), if the applicable materiality threshold is met.

As drafted, Act 136 does not expressly require that amendments to existing management, service, tax allocation, and cost-sharing agreements be filed, because such existing intercompany agreements were not previously subject to the Form D filing requirements. Additionally, Act 136 does not expressly require that amendments to all guarantees and intercompany reinsurance pooling agreements be filed, because such agreements were not previously subject to the Form D filing requirement unless the applicable materiality threshold was met. Pending formal guidance from the Insurance Department, insurers may wish to adopt a conservative interpretation and make a Form D filing for future amendments or modifications of these types of existing agreements or seek guidance from the Insurance Department.

When a Form D filing is made with respect to an amendment or modification of an intercompany agreement, the insurer must include the reasons for the change and describe the financial impact on the insurer.

Post-Transaction Notice

Act 136 newly requires that an insurer notify the Insurance Department of the termination of an agreement if the agreement was previously filed under a Form D filing. The notice must be provided to the Insurance Department within 30 days after termination of the agreement. Accordingly insurers will need to submit the required notification following the termination of an agreement relating to a sale, purchase, exchange, loan, extension of credit, investment or pledge of assets, and to existing intercompany reinsurance agreements, if such agreements were previously the subject of a Form D filing with the Insurance Department.

As drafted, Act 136 does not expressly require that an insurer provide notification to the Insurance Department for the termination of existing management, service, tax allocation, guarantee and cost-sharing agreements, because such existing intercompany agreements were not previously subject to the Form D filing requirements. Additionally, Act 136 does not expressly require notification to the Insurance Department for termination of guarantees or intercompany reinsurance pooling

agreements, unless the agreement was previously filed under a Form D filing. Once again, pending formal guidance from the Insurance Department, insurers may wish to notify the Insurance Department upon the termination of such intercompany agreements if the agreement would now be subject to the filing requirements under the IHCA as amended by Act 136 or seek guidance from the Insurance Department.

Disclaimers of Affiliation

Under the IHCA, a person may file a disclaimer of affiliation with a registered insurer and such filings will continue to be permitted under Act 136. Prior to Act 136, once a disclaimer was effective, the insurer was relieved of any duty to, *inter alia*, report transactions arising out of the insurer's relationship with such person, unless the Insurance Department disallowed the disclaimer. Now, under Act 136, if the disclaimer is approved, the disclaiming person is relieved of the duty to register under the IHCA. However, the statute no longer expressly provides that the insurer is relieved of the duty to report transactions with the disclaiming person.

Public and Regulator Access to Filings

The current IHCA provides that Form B and Form D filings, and disclaimers of affiliation are protected from public disclosure under Pennsylvania's Right-to-Know Law. Act 136 did not change the existing law regarding such filings.

Act 136 authorizes the Insurance Department to share information obtained under the IHCA, including Form B and Form D filings, with insurance regulators in other states, law enforcement officials in Pennsylvania or other jurisdictions, the International Association of Insurance Supervisors, NAIC, and members of any supervisory college.

Effective Date

The changes discussed in this Alert become effective September 3, 2012.

Conclusion

Pennsylvania domestic insurers within an insurance holding company system should review the composition of their board and committees and all of their currently existing intercompany agreements and transactions, and any future amendments thereto, to help assure IHCA filings are made as required under the changes made by Act 136.

This Alert discusses only some of the changes made by Act 136 and only certain of the applicable filing requirements. Because these changes are new, and no regulatory guidance or regulations have been issued as yet, the interpretations of the new statutory requirements as discussed herein are subject to change.

The attorneys in our Corporate and Regulatory practice group are available to provide assistance with respect to specific transactions regulated under the IHCA or otherwise providing advice on the changes to the IHCA enacted by Act 136. Please feel free to contact Linda Kaiser Conley or James Potts for advice and assistance.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact:

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