

ClientAlert

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Recently Announced Merger Underscores Corporate Governance Requirements for Insurers

The recently announced acquisition of publicly held insurer FPIC Insurance Group, Inc. by The Doctors Company illustrates some of the potential complexities involved in navigating recent insurance-law reforms on internal controls, particularly in the M&A context. Specifically, the FPIC-Doctors merger demonstrates how insurance companies can be subjected to more stringent board composition requirements as a result of being acquired.

On May 24, FPIC and Doctors (both engaged primarily in medical professional liability insurance) announced that they had entered into a definitive merger agreement pursuant to which FPIC stockholders would receive cash consideration of \$42.00 per share in exchange for their FPIC stock, and FPIC would become wholly owned by Doctors. FPIC is a NASDAQ-listed holding company whose insurance company subsidiaries are domiciled in Florida, Missouri and Texas. Doctors is a California-domiciled interinsurance exchange owned by its members. As a result of this combination, one or more FPIC insurance subsidiaries may ultimately become required to change their audit committee composition and possibly add new directors, as described below.

Beginning in 2009, each of Florida, Missouri and Texas amended its insurance laws to incorporate the latest National Association of Insurance Commissioners ("NAIC") Annual Financial Reporting Model Regulation, commonly known as the Model Audit Rule ("MAR").¹ The MAR itself was amended by the NAIC most recently in 2006 in an effort to strengthen insurance company internal controls and financial reporting; among other things, these amendments required insurance company audit committees to include independent² directors among their members.³ As insurers domiciled in these states, the FPIC insurance subsidiaries are subject to these requirements currently.

These 2006 MAR amendments, including the audit committee requirements, followed years of discussion at the NAIC concerning whether insurers should be subject to heightened standards on corporate governance and internal controls generally. During this debate, advocates of heightened standards argued that it would be incongruous for public companies to be subject to requirements such

¹ NAIC Model Laws, Regulations and Guidelines 205-1, hereinafter cited as "MAR."

² Under the MAR, in order to be considered independent, an audit committee member may not, other than in his capacity as a committee or board member, accept any consulting, advisory or other compensatory fee from the insurer or be an affiliated person of the entity or any subsidiary thereof. MAR §14(C). In a "Drafting Note," the MAR states that in "determining independence, the commissioner shall consider utilizing guidance provided in the SEC's Final Rule No. 33-8220, *Standards Relating to Listed Company Audit Committees adopted April 9, 2003*." MAR §14 Drafting Note. The SEC rule referred to is a comprehensive roadmap on director independence adopted shortly following the passage of the Sarbanes-Oxley Act of 2002. The Drafting Note does not specifically appear in the Florida, Missouri or Texas versions of the MAR.

³ Fla. Admin. Code §690-137.002(14); Rev. Stat. Mo. §375.1053(1); 28 Tex. Admin. Code §7.88(k)(1)(C).

as those under the Sarbanes-Oxley Act of 2002⁴ but for insurers – supposedly more rigorously regulated – not to be subject to such standards. Opponents argued that insurers had legitimately chosen non-stock or non-public organizational forms in the past in part because of the flexibility permitted in observing governance requirements imposed on publicly traded stock companies. In addition, opponents argued, it was precisely *because* insurers were so highly regulated in their various activities that the logic of subjecting them to heightened audit requirements did not apply. Public companies, after all, were not necessarily regulated, and therefore making audit processes more rigorous would provide useful assurance to investors who otherwise wouldn't have a window on the company's activities. Insurers, by contrast, were already subject to, and policyholders were protected by, strict regulatory oversight.

Ultimately what the NAIC adopted in 2006 was essentially a compromise position. Insurers, even those organized under other forms providing more flexibility (such as mutuals or exchanges), would be subject to these heightened standards. However, with respect to audit committee independence,

- audit committee independence requirements were imposed on a graduating scale according to insurer size, with insurers whose annual premiums are \$300,000,000 or less not having to have any independent members on their audit committees, those with premiums over \$300,000,000 but less than \$500,000,000 required to have a majority of their audit committees be independent directors, and those over \$500,000,000 required to have audit committees that are at least 75% independent⁵ (nevertheless, all insurers regardless of size are "encouraged" to have a supermajority independent audit committee⁶);
- an insurer has the option of being able to designate its parent company's audit committee as its own for purposes of the MAR;⁷
- transitional periods are provided to accommodate insurers who become subject to these requirements in the future as a result of acquisitions or other circumstances;⁸ and
- insurers that are part of a holding company group that is already subject to specific elements of Sarbanes-Oxley would be exempt from certain aspects of the MAR, including the new audit committee independence requirements.⁹

As a public company, FPIC has historically been subject to the requirements of the Federal securities laws including Sarbanes-Oxley. As a result, FPIC's insurance company subsidiaries are entitled to the exemption in the fourth bullet point above and need not have independent audit committee members at all. However, this could change by virtue of the merger.

When the merger is completed, FPIC's subsidiaries will continue to be wholly owned by FPIC, but FPIC in turn will be a subsidiary of Doctors. The merger agreement contemplates that FPIC will de-list from

⁴ 15 USC §7201 *et seq.*, hereinafter cited as "SOX".

⁵ MAR §14(G). *See* Fla. Admin. Code §690-137.002(14)(g); Rev. Stat. Mo. §375.1053(8); 28 Tex. Admin. Code §7.88(k)(2).

⁶ MAR §14(G) Note A. *See* Fla. Admin. Code §690-137.002(14)(g) Note A; neither Missouri nor Texas has adopted this provision as part of its MAR.

⁷ MAR §14(E). *See* Fla. Admin. Code §690-137.002(14)(e); Rev. Stat. Mo. §375.1053(6); 28 Tex. Admin. Code §7.88(k)(10).

⁸ MAR §17(F). *See* Fla. Admin. Code §690-137.002(17)(e); Rev. Stat. Mo. §375.1052(5); 28 Tex. Admin. Code §7.88(n)(1).

⁹ MAR §14. *See* Fla. Admin. Code §690-137.002(14); Rev. Stat. Mo. §375.1053(1); 28 Tex. Admin. Code §7.88(k)(1)(c).

NASDAQ;¹⁰ it can be expected that FPIC will no longer be required to file Securities Exchange Act reports or even to have a consolidated GAAP audit conducted every year as at present.

Doctors is not required to have a SOX-compliant audit committee (which must be entirely composed of independent persons¹¹) as it is neither a stock nor a publicly held company. As a result, the FPIC subsidiaries will no longer have the ability to rely on a SOX-compliant parent in structuring their audit committees. As long as their individual size remains under \$300,000,000, this should not matter. But as premiums grow, having independent directors could emerge as a requirement. Any of these insurers crossing the \$300,000,000 threshold in a future year will be required to engage independent directors in sufficient numbers to constitute a compliant audit committee, which could prove challenging. At any time that these insurers become subject to these requirements, they will have a year under the MAR to comply.¹²

Alternatively, an avenue exists under the MAR to deem the parent company's audit committee as the insurer's for purposes of the MAR, as referred to above.¹³ Under this approach, Doctors — which would then be a controlling entity — could elect to have its own audit committee deemed to be that of each of the FPIC insurers, solely for purposes of the MAR. Doctors' audit committee would have to be compliant with the independence requirements discussed above in order to be a suitable substitute for distinct audit committees at the subsidiaries. Still, these requirements are less strict than SOX itself, which requires 100% audit committee independence as mentioned above.

Insurance regulators are increasingly focused on these requirements, and we are aware of recent M&A deals in which corporate governance issues were raised as part of the Form A (application for approval) process. Now that the 2006 MAR requirements are in effect generally among the various states, and scrutiny of boards and management is at an all-time high, it can be expected that M&A participants will have to be alert to regulatory sensitivities as well as optics in structuring post-merger boards. Being fluent with the relevant requirements and options, and knowing when they become effective to a particular company post-merger, will be critical to deal participants in obtaining Form A approvals with regulators and doing so without incurring unnecessary regulatory conditions. And because Form A applications frequently involve rigorous vetting, background-checking and even fingerprinting of prospective officers and directors of the acquiring and acquired companies — items that can significantly hold up a Form A approval — it's never too early in a deal to begin thinking about these issues.

¹⁰ Agreement and Plan of Merger by and among The Doctors Company, Fountain Acquisition Corp., and FPIC Insurance Group, Inc., dated as of May 23, 2011, available as Exh. 2.1 to Current Report on Form 8-K of FPIC Insurance Group, Inc. dated May 23, 2011, at http://www.sec.gov/Archives/edgar/data/-1010247/000090951811000203/mm05-2411_8k.htm, §5.2.

¹¹ SOX §10A(m)(3) (15 USC §78j-1(m)(3)).

¹² Fla. Admin. Code §690-137.002(17)(e); Rev. Stat. Mo. §375.1052(5); 28 Tex. Admin. Code §7.88(n)(1).

¹³ MAR §14(E). See Fla. Admin. Code §690-137.002(14)(e); Rev. Stat. Mo. §375.1053(6); 28 Tex. Admin. Code §7.88(k)(10).

For More Information

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