

INVESTMENTS IN APARTMENT PROJECTS OR UNIMPROVED REAL ESTATE BY SUBSIDIARIES OF INSURERS AUTHORIZED TO DO BUSINESS IN TEXAS

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Introduction

Examiners of the Texas Department of Insurance have recently been challenging and refusing to admit investments in subsidiaries by insurers authorized to do business in Texas when such subsidiaries hold investments in unimproved real estate and apartment projects, contending that such investments violate both Texas laws prohibiting direct investments by insurers in such projects¹ and the Texas Insurance Holding Company System Regulatory Act (the “Holding Company Act”) which, the examiners contend, prohibits indirect actions by insurers that would otherwise violate the Code.²

Because of the prohibitions against the direct ownership in unimproved real estate and apartment projects by insurers authorized to do business in Texas, a number of insurers are making such investments through development subsidiaries, limited partnerships, real estate investment trusts or other such entities. While a number of insurers authorized to do business in Texas do not participate in any such projects in Texas, they do hold such investments in other states, believing that they would not be prohibited. However, neither TEX. INS. CODE ANN. article 3.33 nor article 2.10 prescribe any such geographical limitation, and the prohibitions apply to any insurer authorized to do business in Texas, no matter where the property is located.³

The purpose of this article is to examine the Department’s position and determine whether it is valid.

Prohibitions on Certain Direct Real Estate Investments

TEX. INS. CODE ANN. article 3.33 governs investments by life, accident and health insurers in Texas. Subsection 4(1)(2) allows investments by life insurers in certain investment property “or participations therein,” but specifically prohibits investments in unimproved real estate or apartment projects:

“[N]othing in this Article shall allow ownership of, development of, or equity interest in any residential property or subdivision, single or multi-unit family dwelling property, or undeveloped real estate for the purpose of subdivision for or development of residential, single, or multi-unit family dwellings . . . “

The same language is found in section 10(b) of TEX. INS. CODE ANN. article 2.10, which governs property and casualty insurers.

With respect to life insurers, the examiners may be interpreting the term “equity interest” in subsection 4(1)(2) to mean an *indirect* equity interest through the ownership of “equity interests” as described in subsection 4(h) of TEX. INS. CODE ANN. article 3.33, which allows life insurers to invest in common stocks, limited partnership interests, real estate investment trusts, and other similar “equity” investments.⁴ This interpretation strains the language of subsection 4(1)(2) and, if applied literally, would lead to the absurd result that a life insurer would have to investigate, before making *any* equity investment under subsection 4(h), whether the issuer held any real estate investments that were prohibited under subsection 4(1)(2). A better reading of “equity interest” in subsection 4(1)(2), which would fit the context of that subsection, is in the traditional sense of an “equity interest” in real estate, and interpreting the language as “an equity interest *in an entity holding an equity interest* in real estate,” as the examiners would suggest.

While subsection 4(o) of TEX. INS. CODE ANN. article 3.33 (the “basket clause”) permits a life insurer to hold “investments which are not otherwise specified by this article,” they must not be “specifically prohibited by statute.” Property and casualty insurers have a “basket clause” found in subsection (2) of TEX. INS. CODE ANN. article 2.10-1, which contains a similar proscription for investments which are “not otherwise specifically prohibited by law.”

In short, there is a clear prohibition against direct investments in multi-family real estate or undeveloped real estate by insurers incorporated in Texas or foreign insurers holding certificates of authority to do business in the State. The

question then becomes whether these insurers may lawfully hold such investments through subsidiaries. The Texas Department of Insurance takes the position that such investments would be unlawful.

Investment Subsidiaries

While a life insurer may not hold such real estate investments directly, it may, however, under subsection 4(h) of TEX. INS. CODE ANN. article 3.33, hold “equity interests, including common stock, equity investment in an investment company . . . , real estate investment trust, limited partnership interests, warrants or other rights to acquire equity interests in any business entity that is organized under the law of the United States, any of its states, Canada or any province of Canada.” Art. 3.33, section (h). Note that the permission to invest in real estate investment trusts is not limited to only real estate investment trusts holding interests in real estate that could be held directly by the insurer, and many such trusts invest in apartment projects and residential real estate developments. In fact, section 7(e) of TEX. INS. CODE ANN. article 3.33, which formerly provided that “an insurer’s participation in a partnership or joint venture shall be limited to those partnerships or joint ventures whose purposes are for investment in properties authorized under subsections (k), (l) and (m) of section 4 of this article . . .” was repealed in 1997.⁵ Such investments in any one business entity may not exceed 15% of the life insurer’s capital and surplus; and all of such investments may not, in the aggregate, exceed 25% of its assets. Further, “an insurer shall not be permitted to invest in a partnership, as a general partner, except through an investment subsidiary.” Subsection (h)(2), TEX. INS. CODE ANN. art. 3.33.

Although neither subsection 4(h) of TEX. INS. CODE ANN. article 3.33 nor section 5 of TEX. INS. CODE ANN. article 2.10 place any restrictions on the percentage of outstanding securities of an issuer an insurer may own, once ownership exceeds ten percent of the outstanding voting securities of an issuer, there is a presumption that the insurer “controls” the issuer, and the issuer is, therefore, deemed a “subsidiary” of the insurer. TEX. INS. CODE ANN. art. 21.49-1, subsections 2(d) and (m). Section 6A of TEX. INS. CODE ANN. article 21.49-1 provides guidelines for the valuation of an insurer’s investments in subsidiaries or affiliates. Section 6A(a) provides that, “for financial statement purposes only, and not to determine the amount invested in accordance with section 6(b)(1) of this article,” an insurer should value its investments in subsidiaries on the basis of the greater of:

- (a) net stockholder equity value “*adjusted to include the value of only such of the assets of such subsidiary as would constitute lawful investments for the insurer if acquired or held directly by the insurer;*” (section 6A(a)(1); emphasis added) or
- (b) “one of the following bases appropriate to each type of subsidiary or affiliate owned by it,” including “net worth . . . determined in accordance with generally accepted accounting principles,” provided that the financial statements of the subsidiary have been audited (sec. 6A(b)(2)(i)); “cost of the stock of the subsidiary or affiliate . . . adjusted to reflect subsequent operating results” (sec. 6A(b)(2)(ii)); or market value of the subsidiary’s stock “if the stock is listed on a national securities exchange” (sec. 6A(b)(2)(iii)).

If a non-insurer subsidiary is valued at market value in accordance with subsection 6A(a)(2)(iii),

there shall be deducted from otherwise determined value a sum equal to the value claimed for any of its assets which would not constitute admitted assets for the insurer if held directly by the insurer, if such assets

- (1) are held by the subsidiary or affiliate but used, under a lease agreement or otherwise, significantly in the conduct of the insurer’s business; or
- (2) were acquired from or purchased for the benefit or use of the insurer by the subsidiary or affiliate under specific circumstances that, in the opinion of the Commissioner, support a reasonable finding that the primary purpose of such acquisition or purchase was the evasion or avoidance of the Insurance Code. (Section 6A(e); emphasis added.)

The necessary implication of the language in subsections 6A(a) and (e) highlighted above is that subsidiaries or affiliates of an insurer might make investments that would not be lawful if held directly by the insurer, and in that situation the

insurer would not be deemed to have violated the Code by doing something indirectly that it could not do directly, but the subsidiary's ownership of these investments might impact the valuation of the subsidiary on the insurer's financial statements.

Section 8 of Article 21.49-1

The Department's interpretation of section 8 of TEX. INS. CODE ANN. article 21.49-1, which it reads as prohibiting an insurer from utilizing a subsidiary or affiliate to do indirectly what the insurer otherwise could not do directly, conflicts sharply with the language in section 6A, and renders it meaningless. If a subsidiary of an insurer was prohibited from making investments that the insurer could not make directly, why would such investments have to be discounted in some situations by the insurer in valuing its investment in the subsidiary? The fact of the matter is that the language of section 8 does *not* conflict with section 6A; it is only the Department's reading of section 8 that creates the ambiguity.

Section 8 actually provides as follows:

No holding company or controlled person shall directly or indirectly or through another person do or cause to be done for or on behalf of the controlled insurer any act intended to affect, influence, change, or alter in the insurance operations of the insurer which, if done by the insurer acting alone, would violate this code. Provided, however, this section shall not limit or prohibit such holding company or person within the holding company system from doing any type of business that would be normal and natural to such person if it were not within the holding company system so long as such business is conducted on behalf of such person. (emphasis added).

The business operations of certain investment corporations, real estate investment trusts, and limited partnerships are to hold investments in undeveloped real estate or apartment projects. They are often organized by insurers for that purpose. A plain reading of section 6A(a)(1) requires the conclusion that these entities clearly may hold investments that might not constitute lawful investments of the insurers if held directly by these insurers. The holding of these investments is not an act "intended to affect, influence, change, or alter the insurance operations" of the insurers.

Conclusion

Consequently, one can argue that the Texas Insurance Department examiners are wrong, and that section 8 of TEX. INS. CODE ANN. article 21.49-1 does not prohibit an insurer authorized to do business in Texas from holding investments in subsidiaries investing in undeveloped real estate or apartment projects, even though they could not hold such investments directly under TEX. INS. CODE ANN. article 3.33, subsection 4(l) or TEX. INS. CODE ANN. article 2.10, section 5.

Endnotes

1. For life, accident and health companies, such prohibitions are found in section 4(l) of TEX. INS. CODE ANN. article 3.33. A similar prohibition is found in section 10(b) of TEX. INS. CODE ANN. article 2.10, which allows real estate investments for certain property and casualty insurers having assets in excess of \$500 million.
2. The examiners base their argument on section 8 of TEX. INS. CODE ANN. article 21.49-1.
3. TEX. INS. CODE ANN. article 3.41 provides that "the assets of any 'foreign company' [defined as "any life, accident and health insurance company organized under the laws of any other state"] shall be invested in securities or property of the same classes permitted by the laws of this State as to 'domestic' companies or by other laws of this State in securities approved by the Board of Insurance Commissioners as being of substantially the same grade." Section 9 of TEX. INS. CODE ANN. article 21.43 provides that foreign insurers holding a certificate of authority in Texas "are deemed to have agreed to fully comply with [the provisions of the Texas Insurance Code] as a prerequisite to the right to engage in business in this state," and subjects property and casualty insurers to investment laws applicable to Texas domestic insurers.

4. Subsection 5 of TEX. INS. CODE ANN. article 2.10 permits a property and casualty insurer to invest its funds “over and above its minimum capital and surplus” in the “stocks, bonds, debentures, bills of exchange or other commercial notes or bills and securities of any solvent dividend paying corporation at time of purchase, incorporated under the laws of this state, or of any of State of the United States . . .” Subsection 5(a) allows investment of funds over and above minimum capital and surplus and required reserves “in the stocks, bonds or debentures of any solvent corporation. . .” The term “equity interest” is not used in this article.
5. H.B. 909, Section 6. 75th Leg., Reg. Session, Ch. 556. Property and casualty insurers were never subject to such restrictions.