

## INVESTMENTS IN SUBSIDIARIES — SOME SPECIAL PROBLEMS

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### *Introduction*

**General.** This article examines some edge-of-the-envelope questions dealing with the effects that investments in subsidiaries may have on an insurance company's policyholders' surplus account. It emphasizes statutory accounting and regulatory perceptions in a highly technical area, with focus on some areas where the price imposed on an insurance company for taking the wrong course of action could be absolutely calamitous.

Insurance company investment laws in Tennessee and elsewhere permit insurance companies to acquire or establish subsidiaries and to account for the acquisitions in a manner which treats subsidiary capital and surplus (or policyholders' surplus) as an insurance company asset, subject to statutory limitations. These provisions authorize investments entirely in excess of the usual investment limits on common stock investments.<sup>1</sup> This is sometimes called "stacking" since it permits subsidiaries to be stacked in the determination of the company's surplus.

An example of stacking may be helpful. If holding company and general business corporation AT Holdings owns all of the outstanding shares of stock of A Life Insurance Company, which has assets of 1,000 and surplus of 100, and agrees to acquire T Life Insurance Company, which has assets of 100 and policyholders' surplus of 10, at a cost of 10, and to do so with A's cash, the acquisition may be effected directly by AT Holdings, or it may be indirectly effected through A Life Insurance Company. Since the cash to be used is that of A Life Insurance Company in either instance, direct acquisition of T Life Insurance Company by AT Holdings will require a distribution of some type, which would reduce the policyholders' surplus of A Life Insurance Company; here, the reduction would be 10 and A Life Insurance Company would have policyholders' surplus of 90 immediately after the acquisition.

If the acquisition by AT Holdings was indirect, in the sense that A Life Insurance Company acquired T Life Insurance Company, rather than as a direct acquisition by AT Holdings with distribution proceeds, A Life Insurance Company would emerge from closing with undiminished surplus of 100, effectively replacing 10 units of cash with 10 units of investment in subsidiaries; the subsidiary's surplus would continue to be 10. Stacking also increases assets and creates flexibility for an insurance company to invest somewhat more heavily in those investments which are limited to a percentage of an insurance company's assets.<sup>2</sup>

This article examines stacking, its limits, and emphasizes traps for the unwary.

**Historical Perspective.** With rare exceptions, insurance companies are now and long have been conservatively managed. However, for two reasons they may now be more heavily invested in subsidiaries than has ever been the case. First, many companies use "stacking" in their acquisitions. A second and recent major phenomenon involves asset securitizations in which companies transfer certain of their relatively illiquid investments, usually commercial mortgage loans, to a bankruptcy remote subsidiary, and these loans are used to collateralize a public or private offering of securities; proceeds from the sale of securities go to the insurance company where they are usually redeployed into more liquid assets. Asset securitizations may be rating agency driven in that they replace relatively illiquid investments with more liquid investments and tend to help claims payable ratings. After the sale has occurred, any remaining insurance company investment in subsidiaries will represent an amount equal to any unsold portion of the securities backed by the transferred loans.

**More Complicated Example.** A second, more complicated, and far more aggressive example may be helpful. This example is posed only for purposes of demonstrating that stacking can make a dramatic difference, and its use is not intended to suggest that it would or should receive required regulatory approvals. Assume here that general business corporation A owns all of the issued and outstanding shares of stock of insurance company B and wants to acquire, directly or through B, all of the issued and outstanding shares of stock of insurance company C. Further assume that B's pre-acquisition financial characteristics determined under statutory accounting practices include:

(i)	assets	1,000
(ii)	reserves and other liabilities	900
(iii)	policyholders' surplus	100

and that C's financial characteristics include:

(i)	assets	200
(ii)	reserves and other liabilities	150
(iii)	policyholders' surplus	50

Finally, assume a cash purchase price of 75 (which includes a premium of \$25 over book), that company licensing or other considerations<sup>3</sup> effectively preclude a cash merger of Company B and Company C, and that Company B cash is used to effect the acquisition.

If parent general business corporation A receives a cash dividend of 75 from Company B to effect the acquisition, this would usually require prior approval as an extraordinary dividend. Payment would result in a reduction of insurance Company B's post-acquisition policyholders' surplus by the entire purchase price of 75, which is likely to be unacceptable to regulators. Acquisition of the stock of insurance Company C by insurance Company B, rather than by its parent company, would entirely avoid the need for securing extraordinary dividend approval (although acquisition approval of either method would be required under holding company systems statutes) and would permit insurance Company B to carry Company C's policyholder surplus as an admitted asset.<sup>4</sup> Results are contrasted below:

	<b>Company B Post-Acquisition</b>	
	<b>Direct Acquisition</b>	<b>Acquisition by Parent with Company B Cash</b>
Assets	975	925
Reserves and Other Liabilities	900	900
Policyholders' Surplus	75	25

Clearly, at least at first pass, Company B looks financially healthier for having effected a direct acquisition. Because of the acquisition method selected, the policyholders' surplus of Company C supports its own operations and indirectly supports (through "stacking") the operations of Company B (to the extent of 50). This involves no sleight-of-hand accounting; Company B owns the stock of Company C. The shares of stock of Company C may be a considerably less liquid asset than the assets that its shares replaced, but Company C shares could almost certainly be sold at some time and at some price. All sale proceeds would belong to and be received by Company B.

### *The Statutes*

**How They Work.** Tennessee's life insurance company investment laws permit companies to invest amounts substantially equal to their capital and surplus<sup>5</sup> in shares of one or more subsidiaries, and investment laws for other insurance companies may permit them to invest some of their free capital and surplus in one or more subsidiaries.<sup>6</sup> These investments are wholly in excess of the limits on investments in common stocks of companies which are not subsidiaries.<sup>7</sup> It is very important to note that regulatory consent is required for life insurance company investment in subsidiaries if they are in excess of the formula maximum and are required at any level at all for other such insurance company investments.<sup>8</sup> Some types of subsidiaries, such as real estate companies are "looked through" and treated as if the subsidiary assets were directly owned by the insurance company.<sup>9</sup> These laws were initially adopted well prior to the recent waves of consolidations and asset securitization.

**The Death Spiral Problem.** The most frequently imposed remedy for noncompliance with insurance company investment laws is to deny admitted asset treatment to the asset invested in, or to “nonadmit” the asset. In the context of the second of the above examples, amending the direct acquisition example to nonadmit bonds carried by Company B at 30 should have an end result of Company B’s policyholders’ surplus being reduced from 75 to 45, maybe a little more than 45 due to some contra-adjustments to valuation reserves. If this were the end result, the company’s surplus-to-liabilities ratio would be reduced significantly (to slightly less than 5%), which might or might not result in a suspension of its authority to accept new business. However, where stacking has been used, the effect of an unrelated nonadmission can have a consequent effect on investment in subsidiaries, which can be an enormously more serious matter and arises entirely out of the way that statutes are written. This consequent effect can result in a further nonadmission of investment in subsidiaries because that investment in subsidiaries (50) would now exceed the statutory maximum of policyholders’ surplus (now 45), so an additional 5 of investment in subsidiaries must be nonadmitted. This nonadmission of investment in subsidiaries (by 5, or from 50 to 45) would in turn result in policyholders’ surplus being further reduced (in like amount of 5, or to 40), with another consequent asset disallowance of 5 followed by another policyholders’ surplus reduction, in an economic death spiral of adjustments followed by consequent adjustments, until Company B becomes insolvent. It is fair to think of this as an economic death spiral because the process cannot be stopped short of insolvency once it begins. However characterized, this traps only the unwary. The trap is triggered whenever investment in subsidiaries exceeds the statutory limit. Almost any change in the amount of the Company’s investment in subsidiaries would necessarily grow or reduce the statutory limit of policyholders’ surplus on a dollar-for-dollar basis, so negative changes in the admissibility or in the values of other assets, or the incurring of operating losses, would constitute the larger risk of triggering the trap – these erode the statutory limit without having any consequent effect at all on investment in subsidiaries.

### *Practice Implications*

1. Be Aware – and Be Wary. This has all of the characteristics of a trap for the unwary.
2. Secure Commissioner Consent. Tennessee’s life insurance company statutes permit the Commissioner to legitimize what would otherwise be an impermissible investment, which presents a “silver bullet” solution to the problem. Accordingly, in Tennessee it has to be a good idea to secure Commissioner approval of life insurance company investments in subsidiaries; those approvals (i) must take into account their financial effect on the company and (ii) are probably easier to secure when they are not needed than when they are.
3. Know the Statutes. Tennessee’s life insurance company statutes call for formulaic calculation, effectively a fraction that absolutely must have a numerator smaller than its denominator, to be made with values going into the numerator determined on the lower of historical cost or market. This may be a low valuation method and can be helpful. Timing of comparisons can also be very important.
4. Think Expansively. An operating loss incurred in the insurance company parent can trigger an economic death spiral while the same loss, shifted entirely or partially to an insurance company subsidiary of the insurance company parent (even when accompanied by a parent company guarantee), would trigger nothing.<sup>10</sup> Accordingly, it can be helpful to think expansively.
5. Think Legislation. These statutes were enacted in an entirely different age, are now outmoded, and would be good subjects for amendment.

### *Endnotes*

1. Emphasis in this article is on Tennessee law, compiled at Tenn. Code Ann., § 56-3-303(b) for life insurance companies and § 56-3-404 for other insurance companies. While limits on article length make it unfeasible to set out a multi-state survey in this article, we did look at laws of other states. Tennessee’s life insurance company limits are probably higher than what is usual in many other states, which seems to be the lesser of a percentage of admitted assets or a percentage of policyholders’ surplus. We will, on request, supply a list of similar statutes in other states. Tennessee’s life insurance section provides:

(b)(1). A domestic life insurance company at the time of original issue or at any other time may acquire one (1) or more subsidiaries, subject to the limitations in subdivision (b)(2). . . . For purposes of this section, “subsidiary” means a corporation in which the insurer owns and holds more than fifty percent (50%) of the voting stock of the corporation.

(2) The acquisition of subsidiaries by a domestic life insurer shall be subject to the following:

(A) Except as provided in subdivisions (b)(2)(B) and (C), the aggregate amount that may be invested in subsidiaries . . . shall not exceed the amount by which the capital and surplus of the insurer exceed the minimum capital and surplus required to form a new company to do the kind or kinds of insurance business the insurer is authorized to transact in this state. . . .;

(B) *A domestic life insurer may invest in excess of the amount permitted in subdivision (b)(2)(A) in the common stock, preferred stock or debt obligations of one (1) or more investment subsidiaries, subject to the limitations in subdivision (a)(15) and, with the approval of the commissioner, a domestic life insurer may invest any amount in excess of the amount permitted in subdivision (b)(2)(A) . . . one (1) or more subsidiaries; provided that after such investment, the insurer’s surplus as regards policyholders shall be reasonable in relation to the insurer’s outstanding liabilities and adequate to its financial needs; and [Underscored material was added in 1998 to facilitate asset securitizations. -- ed.]*

(3) Investments in common stock, preferred stock or debt obligations of subsidiaries made pursuant to this subsection (b) shall not be limited by or be subject to any of the otherwise applicable authorizations, restrictions or limitations applicable to the investments of domestic life insurers, . . . *[Except for real estate subsidiaries. -- ed.]*

(4) Whether any investment pursuant to this subsection (b) meets the applicable requirements thereof shall be determined on a pro forma basis immediately after such investment is made, taking into account:

(A) The capital and surplus of the insurer and the minimum capital and surplus required at that time for a new company to do the same kind or kinds of insurance business the insurer is authorized to transact in this state;

(B) The then outstanding principal balance on all previous investments in debt obligations of subsidiaries; and

(C) The original cost or the current book value, whichever is lower, of all previous investments in the common or preferred stock of subsidiaries.

2. *E.g.*, common and preferred stocks, mortgage loans, certain securities lending transactions, counterparty exposures, hedging transactions, derivatives, swaps.

3. If the company which would disappear in the merger is licensed in some states in which the survivor is not, the time lag in securing licenses for the survivor may dictate that any merger be deferred until some time after acquisition.

4. The excess of purchase price over the acquired company’s policyholders’ surplus is not here used as part of asset valuation, although we think Tennessee statutes probably would permit it to be used.

5. Capital and surplus in excess of the minimum of \$2,000,000 that the statutes generally require as a condition to licensing. Other minimums apply to some other organizations, *e.g.*, credit life reinsurers, title insurance companies, health maintenance organizations.

6. Tenn. Code Ann. § 56-3-404.

7. Tenn. Code Ann. §§ 56-3-303(b) and 56-3-404.
8. Life companies – amounts in excess of the quantity capital and surplus minus \$2,000,000 may be invested in subsidiaries with Commissioner consent. Other companies -- Commissioner approval is required for any such investment and none may be made in excess of the quantity (i) capital and surplus minus (ii) minimum required capital.
9. Tenn. Code Ann. § 56-3-303(b)(2)(C).
10. This would be a related party transaction and might require prior approval under the holding company statute, depending upon transaction size.