Insurance & Reinsurance - Canada

Insurance Company Mergers: A Regulatory Guide

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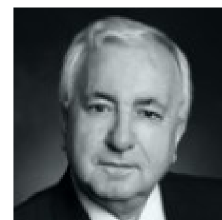

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Introduction

Canada, like many jurisdictions, has an insurance marketplace that is largely characterized by a significant number of competing companies in various lines of business. However, over the last number of years, the market has shown signs of becoming more consolidated. Given the current pressures on the financial marketplace, this trend may be expected to continue. This update outlines the regulatory issues relevant to insurance mergers, particularly in a consolidating marketplace.

Insurance mergers in Canada are subject to specific review under the insurance and banking regimes. Mergers of 'large' insurers are subject to additional regulation. Further, the acquisition of insurance companies by foreign entities may be subject to review under the Investment Canada Act regime. Finally, the Competition Act contains merger control provisions.

Unlike in the United States, in Canada the federal government and the provincial governments each have the power to incorporate and thus regulate corporate proceedings (including mergers) of insurance companies. Most insurance companies are governed by the federal Insurance Companies Act, which deals extensively with mergers. If insurance companies are incorporated under provincial jurisdiction, the insurance legislation of that province will guide the merger process. While the marketplace regulation of insurance is an exclusive provincial power, these provisions are not material to mergers.

The provisions of the federal and provincial laws are both substantive and procedural when dealing with notification requirements.

Financial Institution Merger Review

Federal review
Under the Insurance Companies Act, the acquisition of more than 10% of the voting control of a federally incorporated insurance company requires the approval of the minister of finance.(1) Typically, in such reviews, the minister considers the experience, reputation, regulatory standing and financial strength of the acquirer and will, among other things, require the acquirer's ultimate parent to provide a non-binding support letter regarding the insurer. The acquirer must also provide a three-year business plan for the target, including projected solvency margins. Finally, the acquirer must describe the reasons for and the benefits of the acquisition. If these benefits include streamlining and attendant job losses, these will need to be addressed. The process normally starts with a meeting with the regulator, which involves providing a significant amount of information and takes between three and six months.

If the acquirer of 10% or more of the voting shares in an insurance company is a 'foreign bank' as defined in the Bank Act, such transaction needs the approval of the governor in council (ie, the federal Cabinet).(2) Here the review focuses on plans for the acquirer and its Canadian investments to enter the banking industry (ie, by taking deposits and providing credit). This review is normally carried out in parallel with the ministerial application under the Insurance Companies Act and does not normally add significant time to the approval process.

If two or more insurance companies incorporated under the Insurance Companies Act seek to merge, they must have the amalgamation agreement approved by the superintendent of financial institutions. This agreement must be accompanied by the report of an independent actuary. After approval is received from the superintendent of financial institutions, the amalgamation agreement must be approved by the insurance companies' shareholders, policyholders or members. An application must then be made to the federal minister of finance, who will assess:

- the rationale for the amalgamation;
- the financial statements and projections of each amalgamating company;
- sources of continuing financial support for the amalgamated company;
- the business record of the companies and their corporate leadership; and
- an integration plan, with a view to ensuring that the transaction is in the best interests of the Canadian financial system.(3)

If, instead of acquiring shares in a federal insurance company, the acquirer purchases assets by way of an insurance portfolio, the minister of finance must approve the acquisition.(4) The usual method of asset acquisition is by way of assumption reinsurance, although for small, discrete portfolios, novation is sometimes possible. The ministerial review will assess the impact of the acquisition on the policyholders of both the acquirer and the target company. This review requires the submission of:

- *pro-forma* financial statements;
- a three-year business plan, including projected solvency margins; and
- in the case of life insurance and business with a lengthy tail, the report or opinion of an independent actuary addressing the effects on the policyholders of both companies.

The acquirer must also ensure that it has the authorizations for the classes of business being acquired. Again, the approval process normally takes between three and six months, depending in part on how diligently the required documentation is assembled and submitted. As in the case of share acquisitions, the process includes mandatory publication requirements and entitles policyholders to object, which they occasionally do. If the regulator considers the objections to have any merit, it will require the companies to address them, which can add significant delays to the process and may require modifications to the acquisition.

Finally, if a foreign bank acquires assets rather than shares, federal Cabinet approval is again required and the review will focus on the same factors as those under a share acquisition.

Provincial review
In the case of a portfolio transfer, the acquirer must also ensure that it has the requisite provincial licences for the classes of insurance in each of the provinces or territories where policyholders of the target portfolio reside. In the past, provinces used to process licence applications in parallel with the federal authorizations, but now a number of provinces require the federal authorizations to be in place before they accept applications, which can add several months to the overall approval process.

Insurance companies that are incorporated provincially are generally subject to similar provincial approval requirements. However, there are relatively few such companies and thus mergers and portfolio acquisitions involving them are relatively rare. Accordingly, the provincial approval process is less well defined and involves greater interaction with the provincial regulators. All of these requirements are aimed generally at ensuring the soundness of the financial system, rather than at addressing competition or antitrust-related considerations.

Investment Canada Act

The Investment Canada Act requires that the government be notified of acquisitions of Canadian businesses - including insurance companies - when the assets of the business exceed C$5 million in value and the acquirer is a foreign-controlled company. This will include almost any insurance company acquisition, but the notification obligation is not onerous - it is a brief two-page report that must be filed within 30 days of closing the transaction.

In addition to the notification requirement which applies to all covered transactions, larger transactions subject to the Investment Canada Act must obtain advance government approval. The asset threshold for approval changes each year with inflation, but for 2009 and for investors from most countries in the world (ie, members of the World Trade Organization), the level is set at C$312 million. For insurance companies, this threshold is relatively easy to exceed. Amendments to the Investment Canada Act, which were recently passed by Parliament and are likely to come into effect during Summer 2009, will increase the threshold to C$600 million (and then to C$1 billion in two years). These higher thresholds will be based on 'enterprise value', which

is a concept not defined in the legislation (it will be defined via regulation); but for publicly traded companies it is likely to be equivalent to total market value. However, even with these higher thresholds, a number of insurance acquisitions are expected to exceed the limits and require government approval.

Assuming that there are no issues of national security arising from a proposed acquisition, and that the transaction requires approval, the government has 75 days (an initial 45 days plus 30 days if more time is needed) to review the proposed transaction. A new system for reviewing transactions that may injure national security is a major part of the 2009 amendments to the Investment Canada Act.

Historically, approval under the Investment Canada Act has almost always been obtained, but in order to achieve approval, firms typically must give undertakings to the government, addressing issues such as:

- level of employment;
- Canadian management;
- head office activity in Canada;
- purchases in Canada; and
- research and development.

These undertakings are typically required to be in effect for a period of three years post closing.

There are some exemptions relevant to insurance transactions under the Investment Canada Act. These exemptions will not avoid application of the forthcoming rules, by which the Canadian federal government will be empowered to declare a transaction to be potentially injurious to national security. However, it seems unlikely that this regime would be applied to an insurance transaction.

The first exemption is found in Section 10(1)(h) of the Investment Canada Act, which establishes an exemption for certain banking-related transactions. This section provides that the Investment Canada Act does not apply to "any transaction to which Part XII.01 of the Bank Act applies". Part XII.01 states that the Investment Canada Act does not apply to the following five categories of transaction:

- the acquisition of a bank, a bank holding company, a trust company, a cooperative credit association or "an insurance company or a fraternal benefit society incorporated or formed by or under the Insurance Companies Act". If one of these entities is being acquired by a foreign bank or by an entity associated with a foreign bank, then the exemption applies;
- the establishment of a new Canadian business that is:
  - an insurance business in Canada;
  - a business of a foreign insurance company that is a foreign bank, to which Part XII of the Bank Act does not apply; or
  - an entity associated with a foreign bank to which Part XII does not apply;
- the acquisition or control of a Canadian business by any of the entities listed in the first bullet point above, that is controlled by a foreign bank or by an entity associated with a foreign bank;
- the acquisition of a new Canadian business by a foreign bank to which Part XII of the Bank Act does apply, or by an entity associated with a foreign bank to which that part applies that has a financial establishment in Canada or would have one by virtue of the establishment of a new Canadian business; or
- the acquisition or control of a Canadian business by a foreign bank or an entity associated with a foreign bank.

In case of an acquisition by a foreign business, it is necessary to determine whether that acquirer is "an entity associated with a foreign bank" in order to decide whether any of the above-listed exemptions apply.

The second exemption is found in Section 10(1)(j) of the Investment Canada Act, which establishes an exemption for the acquisition of control of a Canadian business by:

- an insurance company incorporated in Canada that is a company or a provincial company to which the Insurance Companies Act applies, on the condition that the gross investment revenue of the company from the Canadian business is included in computing the income of the company under Section 138(9) of the Income Tax Act;
- a non-resident insurance company whose insurance of risks in Canada has been approved by order of the superintendent of financial institutions under Part XIII of the Insurance Companies Act, on the condition that the gross investment revenue of the company from the Canadian business is included in computing the income of the company under Section 138(9) of the Income Tax Act, and that the voting interests of the entity carrying on the Canadian business, or the assets used in carrying on the

Canadian business, are vested in trust under that part; or

- a corporation incorporated in Canada, whose issued voting shares - other than the qualifying voting shares of directors - are owned by an insurance company described in the first or second bullet points above, or by a corporation controlled directly or indirectly through the ownership of voting shares by such an insurance company, on the condition that, in the case of an insurance company described in the second bullet point above, the voting interests of the entity carrying on the Canadian business, or the assets used in carrying on the Canadian business, are vested in trust under Part XIII of the Insurance Companies Act.

The exemption defined by Section 10(1)(j) of the Investment Canada Act deals with situations involving purchasers that are:

- insurance companies incorporated in Canada;
- non-resident insurance companies approved to insure risks in Canada; and
- corporations incorporated in Canada that are wholly controlled by either of these categories of insurance company.

The exemptions are not open ended. For Canadian-incorporated insurance companies, the exemption applies only "on a condition that the gross investment revenue with a company from the Canadian business is included in computing the income of the company under Section 138(9) of the Income Tax Act".

In addition to being approved under Part XIII of the Insurance Companies Act, non-resident insurance companies must have their gross investment income included in the computing of income of the company under Section 138(9) of the Income Tax Act. The voting interest of the entity carrying on the Canadian business, or the assets used in carrying on the Canadian business, must also be vested in trust under that section of the Income Tax Act.

Finally, corporations controlled by one of these classes of insurance company must vest in trust assets used in carrying on the Canadian business, pursuant to Part XIII of the Insurance Companies Act.(5)

Competition Act

In addition to specific insurance or financial system and foreign ownership review, the Competition Act's merger provisions apply to acquisitions of insurance companies as they apply to acquisitions of any other business.(6) The Competition Bureau will not typically consider the soundness of the financial system as relevant when reviewing a merger; rather, it will apply the test set out in Section 92 of the Competition Act. That test is whether the merger (defined as the "acquisition of control over a significant interest in the whole or part of a business of another person") prevents or lessens, or is likely to prevent or lessen, competition substantially.

The commissioner of competition has released Merger Enforcement Guidelines(7) which indicate that, as a general rule, if the merger does not give rise to a competitor with more than a 35% market share in a relevant market or more than a 10% market share in circumstances in which the top four firms account for more than 65% of the relevant market, then the transaction is unlikely to be challenged. However, even above these thresholds, transactions are frequently not challenged. Given the historic and relatively non-concentrated nature of the Canadian insurance sector (although it is becoming more concentrated), insurance company mergers have not given rise to serious Competition Act challenges in Canada. However, at some point this may change as the sector continues to consolidate.

In addition to substantive merger control, the Competition Act requires pre-notification for mergers exceeding certain size thresholds. Due to the nature of the insurance business, most transactions between companies with any serious operations in Canada would trigger the pre-notification requirement.

The pre-notification rules apply notwithstanding that there may be no substantive competition issues in the merger. Similarly, the substantive merger review rules apply whether the transaction falls above or below the pre-notification thresholds. For the purpose of simplicity in illustrating the pre-notification thresholds, consider a share-purchase transaction. The pre-notification rules also apply, with appropriate modifications, to asset acquisitions, amalgamations and combinations.

For a transaction to be pre-notifiable, the parties to the transaction (ie, the person or persons that propose to acquire the shares and the corporation whose shares are to be acquired), together with their affiliates (ie, all firms with a 50%-plus voting share linkage up and down the chain), must have: (i) aggregate (ie, both sides and all affiliates) gross assets in Canada that exceed C$400 million in value, as shown on their audited financial statements for the most recently completed fiscal year (which must be within the last 15 months); or (ii) aggregate gross revenues from sales in, from or into Canada that exceed C$400 million for the most recently completed fiscal year as

reflected on the said financial statements. Further, the party being acquired must have gross assets in Canada or gross revenues from sales in or from Canada that exceed C$70 million on the said financial statements.

For a share transaction, the acquisition of shares enjoying up to 20% of the votes cast to elect the board of directors in a publicly traded company, or shares enjoying 35% of the votes in a private corporation, will not be subject to pre-notification, regardless of the size thresholds. When the 20% or 35% threshold is exceeded, and again when the 50% threshold is exceeded, pre-notification is required.

If the transaction is pre-notifiable, then to close the transaction it is necessary either (i) to submit the requisite pre-notification forms and allow for the expiration of the 30-day waiting period,(8) or (ii) to request and receive an advance ruling certificate exempting the transaction from pre-notification. Receipt of an advance ruling certificate can often take two weeks or longer, even in cases where there is no substantive competition issue.

Practitioners must keep the pre-notification regime in mind, particularly in international acquisitions, because completing a pre-notifiable transaction without providing notice is a criminal offence and can result in fines of up to C$10,000 per day. Therefore, in an international insurance transaction, the Competition Act notification (and perhaps other Canadian regulatory approvals, including Investment Canada Act approval) is an important item on a checklist.

Large Company Review

Finally, there are special requirements for the mergers or acquisitions of large insurance companies. Where a company has C$2 billion of equity, it is required to list for trading at least 35% of the corporation's voting rights. These traded shares may not be beneficially owned by a major shareholder of the company. This listing must take place within three years of the company attaining the level of C$2 billion of equity.(9)

If a large life insurance company that is owned by its policyholders (a mutual company) converts into an insurance company with publicly traded shares (a converted company),(10) the Insurance Companies Act prohibits a person or entity from holding more than 20% of a class of voting shares or 30% of a class of non-voting shares,(11) except in certain restricted circumstances or with the permission of the minister of finance.(12) The Insurance Companies Act also prohibits a single entity from having direct or indirect control over a converted company, except with ministerial consent.(13)

If a converted company seeks to merge with another converted company or with an insurance company, the companies will need to follow the procedure set out above. If the minister of finance previously granted a ministerial exemption permitting share ownership in excess of the 20% or 30% limit noted above, on application for a merger the minister will consider the effect of the merger on the supervision and regulation of the amalgamated company and any of its affiliates.(14)

Comment

The acquisition of insurance companies in Canada is subject to various reviews, including review under the Competition Act. If the acquirer is non-Canadian, an Investment Canada Act review is also likely. When planning an acquisition of a Canadian insurance company - or the assets of a Canadian insurance company - care must be taken to ensure that transaction timelines permit these reviews to be completed in a timely manner. Although such reviews - at least in circumstances where the acquisition does not adversely impact on the stability of the financial system - are unlikely to create serious problems (assuming that there are no significant antitrust concerns), the parties must still navigate through the various process and timing issues raised by applicable Canadian statutes and regulations.

For further information on this topic please contact James Musgrove, Frank Palmay, Daniel Edmondstone or Hartley Lefton at Lang Michener LLP by telephone (+1 416 360 8600) or by fax (+1 416 365 1719) or by email (jmusgrove@langmichener.ca or fpalmay@langmichener.ca or dedmondstone@langmichener.ca or hlefton@langmichener.ca).

Endnotes

(1) Insurance Companies Act, SC 1991, c 47, s 407.

(2) Bank Act, SC 1991, c 46, s 521.

(3) Insurance Companies Act, SC 1991, c 47, ss 245-250, Office of the Superintendent of Financial Institutions Transaction Instruction A Number 12.

(4) Insurance Companies Act, SC 1991, c 47, s 254.

(5) Insurance Companies Act, SC 1991, c 47, s 582, 611, SOR/2002-450.

(6) There is a minor exception - if the minister of finance certifies to the commissioner of competition that a merger under the Insurance Companies Act is in the public interest, then the merger may not be challenged under the Competition Act. Thus far, the minister has never so certified a merger.

(7) Competition Bureau's Merger Enforcement Guidelines, September 2004: www.cb-bc.gc.ca/eic/site/cb-bc.nsf/eng/01245.html.

(8) There is also the possibility of delay if, during the 30-day waiting period, the Competition Bureau requires that the parties respond to a requirement similar to a 'second request'. If a second request is issued, the time period within which the transaction may not be completed is extended to 30 days from filing a complete response to such request.

(9) Insurance Companies Act, SC 1991, c 47, s 411, 416.

(10) Insurance Companies Act, SC 1991, c 47, s 407(4). As of May 8 2008, four companies met these criteria: Canada Life Insurance Company, Manufacturers Life Insurance Company, Sun Life Assurance Company of Canada and Clarica Life Insurance Company.
(11) Insurance Companies Act, SC 1991, c 47, s 2(3), 407(4). As noted above, the approval of the federal minister of finance is required where a person or entity seeks to acquire or hold more than 10% of any class of shares of the company. S 8, 407(1).

(12) Insurance Companies Act, SC 1991, c 47, s 407, SOR/99-129.

(13) Insurance Companies Act, SC 1991, c 47, s 407.2.

(14) Insurance Companies Act, SC 1991, c 47, s 250(4)(g).

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