INSURANCE JOINT VENTURES: GETTING IT RIGHT

A lecture by Alexandra Booth and Sean Sydenham

These notes are derived from a talk by Alexandra Booth and Sean Sydenham of Elborne Mitchell, given at Lloyd's Old Library on Thursday 29 July 2010.

Where specific reference is made to the law it is to English law as at 29 July 2010.

For specific advice, you should please contact Alexandra Booth, Sean Sydenham or the partner with whom you usually deal at Elborne Mitchell.

Disclaimer: These Notes are for information only and nothing in them constitutes legal or professional advice. They should not be considered a substitute for legal advice in individual cases; always consult a suitably qualified lawyer on any specific legal problem or matter. Elborne Mitchell assumes no responsibility to recipients of these Notes.
INSURANCE JOINT VENTURES: GETTING IT RIGHT

Back in late June the cover page of *Insurance Day* ran an article on Merger & Acquisition activities in the insurance sector. In that article Marty Becker, Chief Executive of Alterra (a company created by the merger of Max Capital and Harbor Point) was quoted as saying:

“The reality is ‘mergers of equal’ deals are really tough and what makes them tough is they are not financial deals, not mathematical deals – these are strategic and social deals. You’ve got to find a board or management team that views the world the same as the other party and that socially get along.”

Whilst applied to the merger market, the same holds true for joint ventures. And if there is one principle for you to leave with today, it is to do enough due diligence on your proposed joint venture party to ensure they have the same objectives and expectations as yourself in order for the joint venture to succeed.

**So, what is a joint venture?**

A joint venture is a term without any precise legal definition and may be described as an arrangement between two or more parties who pool their resources and collaborate in carrying on a business activity with a view to mutual profit. Those parties may also agree to share the risks involved and the day-to-day management, but the degree to which they do so will vary depending upon the structure for the particular venture which they have chosen.

Under a joint venture arrangement it is common for two or more of the joint venture parties to each provide capital, assets or other resources to the joint venture vehicle being used (such as a company, partnership or Limited Liability Partnership) in exchange for a legal interest in that entity, with the view to carrying on a business, commonly involving expertise provided by each of them.

There are many types of structures which could be used to facilitate a joint venture arrangement and these include:

1. Company (Companies Act 2006)
2. Partnership (Partnership Act 1890)
4. Consortium Agreement
5. Collaboration Agreement
6. Franchise
7. Distribution Agreement

And within the insurance sector we could also include the following as forming some type of joint venture (though not legal entities in their own right):
1. Appointed Representative Agreements
2. Introducer Agreements
3. Marketing / Re-marketing Agreements

In this paper we will be discussing corporate joint ventures, however a number of issues we discuss also apply equally to LLPs and partnerships.

The main documents involved in a corporate joint venture are the Articles of Association and a Shareholders’ Agreement. Shareholders in any private company are likely to find themselves facing many of the same issues which arise in relation to a corporate joint venture, even though they have not labelled their relationship as such and the considerations facing such shareholders can be conventionally dealt with alongside joint ventures.

**So, what are the reasons and motivations of establishing a Joint Venture?**

The reasons and motivation for establishing a joint venture will of course differ in each individual case. Generally speaking a joint venture will be established between companies or individuals as each lack one or more of the resources necessary to establish and carry on a new business, or develop an existing business, but by pooling their resources they are able to do so.

Over the past few years there has been a number of prominent joint ventures, particularly where businesses have wanted to expand market share or increase their geographic coverage but have been unable to do so on their own.

Some of the most recent and prominent joint ventures have included:

1. September 2009 – Tesco and Fortis announced it would go ahead with its motor and household insurance joint venture to become Britain’s second largest car insurer. The joint venture came about as Tesco unwound its financial services link with Royal Bank of Scotland. Only earlier Tesco announced its relationship with RBS’s Direct Line was not working and the joint venture with Fortis gave it greater control over the pricing, sales, marketing and development of insurance products.

2. 25 June 2009 - Barclays Bank and CNP Assurances announced a long-term life insurance joint venture in Spain, Portugal and Italy. Barclays also agreed to enter into a 25 year agreement with CNP for the marketing and distribution of life insurance and pension products through its retail network in Spain, Portugal and Italy.

3. March 2008 – HSBC Insurance (Asia-Pacific) Holdings Limited and Hana Financial Group – Clive Bannister, Group Managing Director of Insurance, HSBC Holdings Ltd stated the aim of the joint venture was “to aggressively expand its business in the Korean life insurance market”. “The joint venture will allow HSBC to extend its growing insurance business to Korea, an economy whose insurance market is the second largest in Asia and the seventh largest globally. Hana HSBC Life Insurance is a joint venture between business partners where each brings expertise and resources to the table to complement one another.”

4. February 2010 – Japan’s Aioi Insurance Company (66.6%) and telecommunication group KDDI Corporation (33.3%) – agreed to form a joint venture for mobile insurance
business in Japan under a joint venture company to be known as Mobile General Insurance Planning Ltd. The project will integrate mobile phone content with non-life insurance services to meet mobile phone user’s lifestyle needs.

5. May 2007 – HSBC and AVIVA announced a joint venture. At the time HSBC had signalled its desperation to boost its sales of insurance by launching a joint venture with AVIVA in an attempt to transform itself into a top 10 insurer in the UK. With only 1% share of the car and house insurance market HSBC admitted it could not achieve its goal of improving performance in this area without the help of an insurance company. AVIVA were to design a range of products to be sold through HSBC branches.

BUT, only months later the joint venture deal was altered.

6. November 2007 – HSBC ends planned joint venture with AVIVA! HSBC stated “At the time we announced we would investigate the idea of a joint venture. We then mutually agreed that both sets of customers would be better served by an informal relationship. We felt this gave us more flexibility”. AVIVA stated, “when we actually sat down and looked how to do this, what we wanted to achieve and how we could do it, it became apparent that we could accomplish it without the need for a joint venture. We’ve been in a relationship with HSBC for the past 23 years. Why should we change something that is already working.”

In any joint venture the needs and the concerns of each joint venture party will be different and will influence the structure the venture is to take. HSBC/AVIVA is one such example whereby the formality and costs of a joint venture company were set aside, to maintain the status quo the parties have enjoyed over the past 23 years – possibly in the form of a Marketing/Re-Marketing Agreement and/or Introducer Agreement, without the need to worry about the FSA regulation of a joint venture company itself, composition of the Board, and other administrative matters associated with the creation of a new joint venture company.

**So, how do we “get it right” and where does it go wrong?**

Joint venture parties are unlikely to have exactly the same aims and expectations and no joint venture is likely to succeed if the terms of its legal and commercial structure fail to match the aims and as far as possible the expectations of the joint venture parties. One of the most important tasks for any advisor or those close to the deal is to ascertian what these are and then to devise a structure which is likely to give effect to them.

For example, joint venture parties who are companies will have different cultures and business philosophies which are guided by the policies of their respective Boards and not necessarily the executives to whom they delegate the supervision of their company interests in the joint venture itself. As such, directors of the joint venture can have their own parent company objectives and policies imposed upon them without much room for autonomy or discretion. However, joint venture parties must also consider recent FSA changes regarding “Parent Significant Influence” which are addressed below.

The interests of an individual joint venture party who is working in the joint venture business is unlikely to be the same as those of a corporate joint venture party. His concern will be to ensure adequate return is received for his labours which would provide some wealth upon which he may retire.
One such example is that of the multi-millionaire Peter Woods, the founder of Esure. Esure is a joint venture company owned by Peter Woods and 70% by HBOS. In September 2008, following the turmoil surrounding the banking sector, Mr Wood saw an opportunity to buy-out HBOS’s 70% interest in Esure. Whilst Mr Woods only had a minority 30% stake in the joint venture he was quoted as saying that he had the “absolute say” until 2012 on any decisions by any shareholders to exit the business, thereby placing him in a comfortable position to buy out HBOS’ interest in Esure.

Different again will be the interests of a private equity joint venture party who will be purely participating for a return on capital and will be less concerned with the long term interests of the joint venture business per se.

Overall the parties will need to strike a balance between conflicting requirements.

So, what are some of the most common conflicting factors which should be addressed?

a) Long term and short term investors

The key factor is to determine whether the parties are long term or short term investors or a mixture of the two.

Many corporate joint venture parties are long term investors. Their primary concern is to establish a profitable venture which will add to the bottom line of the profit and loss account and provide an acceptable return on the capital they have invested. Even if they or their lawyers have inserted appropriate realisation provisions into the documents (such as exit or listing clauses) they may continue to operate the joint venture in such a way that it is not entirely independent of the joint venture party’s own business and therefore a sale will prove difficult, although to do so is usually misguided because there may be a time when it is found that the capital locked up in the venture could be invested more profitably elsewhere.

On the other hand some joint venture parties, and most notably those who are private equity investors, are short term investors, although their horizons may differ considerably. A primary concern may be to achieve capital growth which can be realised by sale, flotation or some other method. Such investors may be prepared to sacrifice early profit for growth, and believe that this will ultimately result in higher value for their investment. Others will require the combination of an income stream with capital growth. Other outside capital providers may desire reasonable commercial income on their money but expect medium term repayment.

b) Achieving early exits

It may not be easy to structure a venture to cater for the needs of a party who desires a realisation earlier than the other joint ventures parties, without putting those other parties in a position whereby they must have to exit early. One solution is for one or more of the parties to the joint venture to grant the exiting party an early exit option, whereby it is able to sell its participation in the joint venture to the other parties who wish to remain at an agreed price or pre-determined method of valuation.

In a recent insurance joint venture in which we were involved a specialist private equity company was forming an insurance broker business with a small group of individuals and a private family investment company. The idea was to build the business and
revenues with a view to selling the business in three years. However, the expectations of some of the key individuals and the family investment company was different to that of the main financial backer of the joint venture. Rather, they saw the joint venture as a longer term business and certainly nothing like the three years the funder had in mind. To manage these expectations it was possible to insert appropriate drafting whereby at the end of the three year term the remaining joint venture parties who wished to continue with the joint venture business could have the right by way of a Call Option to purchase the entire interests of the funder shares in the joint venture based upon an independent valuation of the business. If the Call Option was not exercised within a prescribed period then the whole of the joint venture business could be sold. Structuring a joint venture in this manner recognises and manages the differing expectations of the joint venture parties without the need to dissolve or sell the joint venture outright.

Where the joint venture is structured as a company, another possible route is for the company itself to buy or redeem the outgoing party’s shares by way of a share buyback. But this depends upon the company having sufficient distributable reserves or profits to pay the required amount or being able to issue further shares to fund it. Although, in the case of a private company, redemption out of capital is permitted, the capital will often be fully employed, so that the directors will be unable to make the required declaration that the company will be able to meet its liabilities after making the buyback.

c) Different classes of shares

Where a joint venture is structured as a company, one of the chief tools in meeting the differing requirements of the parties is to issue them with different classes of shares. There are different types of shares and most common tend to be Ordinary Shares which can be designated as A Ordinary Shares and B Ordinary Shares. It is also possible to issue other shares which may recognise preferential rights to dividends or voting entitlements. These are referred to as Preference Shares, Cumulative Preference Shares, Convertible Preference and Redeemable Preference Shares, each having their own rights.

As well as the different type of shares there can be different rights attached to those shares which can in the case of the minority provide minority protection vetoes (for example, rights to appoint directors, declare dividends or capital expenditure). We will discuss some of these minority veto powers later.

So, where does it go wrong?

There are a number of areas where joint ventures can go wrong, but today we have covered three areas of common disputes. These are: (1) deadlock, (2) minority interests, and (3) valuation particularly when it comes to one party wanting to leave the joint venture.

(1) Deadlock (lack of deadlock provisions)

Recognising that disagreement cannot always be avoided, and that an actual deadlock may therefore arise, it is desirable for the documentation of any joint venture to include a procedure for their resolution, since the law provides no effective solution other than the liquidation of the joint venture company.
Where a joint venture is structured between equal parties the situation of deadlock can arise, although it can also arise in cases of unequal joint venture parties where, say, a minority has equal representation on the Board of the joint venture entity.

If two shareholders each have equal voting rights in the joint venture company which has adopted, for example, the Articles of Association in the form of Table A (set out in the Companies Act 1985) or the Model Articles (as set out in the Companies Act 2006) complete deadlock does not necessarily arise.

Firstly, ensure the Chairman has a casting vote at Board meetings. Under the Companies Act 1985, Regulation 50 of Table A Articles of Association gave the Chairman a casting vote at General Meetings and Board Meetings. Note, however, that under the new Companies Act 2006 it is no longer possible for a Chairman to have a casting vote at a meeting of members (as was the case under the old Act). This means that control of the joint venture is in the hands of whichever party a permanent chairman happens to represent. Some joint venture parties may not be happy with this position and it is usual in a joint venture agreement for the position of Chairman to be rotated every alternate year, thereby permitting each joint venture party to have its own Chairman appointed to the Board of the joint venture entity. If both of these provisions are removed such that the Chairman is expressly precluded from having a casting vote then, since an equality of votes will negative the decision under Board discussion, nothing can be resolved unless all the joint venture parties agree.

Not to be confused with the Chairman’s right to a casting vote, is the so-called “gin and tonic clause”. This clause is aimed at situations where a deadlock arises which cannot be resolved by the Board. Under the “gin and tonic clause” the Chairmen of each party meet and attempt to resolve the deadlock in a face-to-face discussion. The theory is that these elder statesmen, who are removed from the detail at the operational level of the joint venture and perhaps can see beyond the cause of the conflict, may be able to find a sensible solution. However, this clause itself does not guarantee a solution as the Chairmen themselves may fail to agree a solution. Indeed, one of them may even fulfill an executive role on the Board of the joint venture which compromises his ability to make an independent decision.

But the point to remember is that although initially each party may secure the appointment of an equal number of directors, this will cease to be the case where a director resigns or retires as Regulation 17 of the Model Articles states that a new director can only be appointed by the Board, or by ordinary resolution in general meeting and neither party will have the ability to secure the appointment of the replacement directors necessary to re-establish equality at the Board level. Therefore the Articles or the Shareholder Agreement of the joint venture must be structured so that each joint venture party has a right to appoint a given number of directors (and also to remove any director and to appoint a replacement). It would also be usual to remove the provisions from the Articles whereby directors resign by rotation (Reg 73-77 of Table A though it has now been removed under the 2006 Act). And since each joint venture party would have the right to appoint their own directors, it would also be usual to remove from the Model Articles Regulation 17 which permit additional directors to be appointed during any period in which either party is temporarily in a minority on the Board.
Appropriate drafting in joint venture documents is critical when it comes to avoiding deadlocks. However, where they cannot be avoided there needs to be a procedure in which to hear and resolve any deadlock. For example, the “gin and tonic” clause mentioned earlier. However, many joint venture agreements allow for an independent expert to decide on the matter (for example, someone appointed by the President of the Law Society, Chartered Insurance Institute, or Lloyd’s). Yet these have their own problems too. This is because business decisions cannot be easily resolved by an independent expert who may not be familiar with the nature of the overall transaction or appropriately qualified to make a decisions based upon an analysis of the underlying deal to be transacted (e.g. risk v reward, valuation).

(2) Failing to protect minority shareholder rights

Not all joint ventures will be a joint venture of equal parties. There are many instances in which one party will be a minority and if the minority party wishes to be given any protection it is critical that it be dealt with in the Articles or a Shareholder Agreement. This is because the general principle of company law is that decisions are made by the majority and the minority is afforded very few rights. In fact, the Courts will not look kindly upon recourse to its discretionary powers if the bargain under which joint venture parties have taken up their membership provides a remedy (Baltic Real Estate [1993] BCLC 503).

The law does recognise that the minority is entitled to a certain degree of protection from the unfettered discretion of the majority. Whilst this paper does not go into any details on these limited rights of protection, they do include:

(a) a right to liquidation on just and equitable grounds (Re Westbourne Galleries);
(b) minority shareholders’ actions, or derivative actions (section 260-264 Companies Act 2006 codifies and replaces the rights previously available under the exception to the Foss v Harbottle rules);
(c) protection against unfair prejudice (section 994-996, Companies Act 2006)

So, how can minority shareholders be protected in a joint venture with a majority party?

Minority protection can generally be divided into positive and negative rights.

Positive rights will include:

(a) Right to appoint directors. This should be one of the most important rights for a minority joint venture party to appoint/remove one or more directors to the Board of the joint venture company, although such right in itself can be of limited use when a minority shareholder has minority representation at Board level with the potential to be outvoted in Board meetings by simple majority. However, if the joint venture company is regulated by the FSA you may require their consent and this issue is addressed below;
(b) Share Rights. Assuming each joint venture party holds ordinary shares, each shareholder would have a right to vote and attend meetings. The Shareholder Agreement must therefore include a provision whereby there is no quorum unless the minority shareholder is represented at a general meeting. However, in
order to avoid situations where a minority shareholder could block every resolution by failing to attend meetings there should be a provision allowing an adjournment of, say 7 days, for the adjourned meeting and if there is no quorum at the adjourned meeting due to the minority shareholder not attending then the shareholders actually present at the adjourned meeting shall be deemed to form a quorum.

(c) Dividend Policy. A provision regarding the dividend policy of the joint venture company is often included in the Shareholder Agreement. Usually, it is the Board by simple majority which has the power to declare dividends. However, a dividend policy in a Shareholders Agreement can state a minimum amount or percentage of profits which must be declared by the Board as payable as a dividend to its shareholders. However, do consider FSA capital requirements to ensure any dividend payment policy does not impact upon working capital and regulatory capital requirements.

(d) Right to appoint an observer. This would permit a minority shareholder to appoint an observer to attend Board meetings and to report back to the minority shareholder. Unless the observer is appointed a Director, they would not have the power to speak or vote on matters by the Board.

(e) “Drag” & “Tag” Rights. Apart from the rights of pre-emption available to all shareholders, Drag and Tag rights also offer protection to minority shareholders. “Drag Rights” work to forcibly “drag” a minority shareholder along with the majority shareholders where a third party seeks to acquire the majority’s shares and insists that the minority’s shares are also acquired by them. Whilst the minority has no say as to whether or not they get “dragged” along, they do have the benefit of achieving the same price for their shares as the majority shareholders. “Tag” rights are rights whereby the minority can choose to tag along with the majority shareholders (rather than be forced) to sell their shares to a bona fide third party at the same price as the majority. With both “drag” and “tag” rights it is also possible to insert wording giving the minority shareholders an “option” (i.e. a call option) to purchase the majority shareholder’s shares at the same price as the third party offer, thereby giving the minority the chance to buy out the whole of the joint venture company.

Negative rights applicable to minority shareholder protection can be divided in two groups – Fundamental and Operational Vetoes.

Fundamental negative rights include:

(a) Changes in share capital
(b) Change in the nature of the joint venture’s business
(c) Liquidation of the joint venture
(d) Sale of the business or material assets
(e) Acquisitions
(f) Making of loans or transactions with connected parties;
(g) Transfer of share (pre-emptive rights)

Operational vetoes include:

(a) Borrowings
(b) Capital expenditure  
(c) Dividends  
(d) Leasing transactions  
(e) Auditors & accounts  
(f) Litigation  
(g) Business Plan  

There are no hard and fast rules as to what the minority may expect by way of protection and vetoes as everything depends upon the circumstances and respective bargaining positions of the parties, and in any case what the minority regards as important.

(3) **Inadequate method to value shares upon the exit of a shareholder**

Many exit provisions under which one shareholder sells shares to another provide for a price to be determined by valuation. A common example is a provision in the pre-emption right clauses on the transfer of shares and at what value they should be transferred.

Share valuation is not a precise science – two different valuers will rarely arrive at the same valuation. In essence, a valuation is always an educated guess as to what a third party would be willing to pay for something in particular circumstances, whereas no-one can know this for certain until a third party actually appears and makes an offer.

Share valuation is a vast subject and its wording in joint venture agreements can often become an area of contention. Since there is more than one basis of valuation it is important that the relevant exit provision clearly specifies which basis is to be used.

Good Leaver/Bad Leaver provisions may be a familiar concept to many people today as it is commonly applied in Shareholder Agreements of private companies where shares are issued to employees. Essentially, if an employee were to leave on “bad terms” (i.e. gross misconduct or fraud) they would get nothing for their shares, whereas a “good leaver” (e.g. leaving upon death, retirement or disability) would usually entitle that person to the market or fair value of their shares.

However, the good leaver/bad leaver provisions don’t fit well with a joint venture where each of the joint venture parties are founders and financially back the joint venture rather than where say, as is the case with employees, they are merely given their shares for nothing.

In such circumstances it may still be appropriate for an exiting joint venture party to receive the market or fair value of their interest in a joint venture regardless of whether or not they are leaving on good or bad terms so as to be given an opportunity of having their financial funding returned, even if only part of it.
So what have been the problems associated with valuations of joint ventures?

It primarily comes down to whether “market value” or “fair value” is used and the assumptions applied when arriving at a value.

The term “market value” is found in the tax legislation and defined in Taxation of Chargeable Gains Act 1992, section 272 as being “the price at which [those assets] might reasonably be expected to fetch on a sale in the open market”. In the case of a valuation for tax purposes the valuer has to assume a hypothetical sale and therefore a hypothetical purchaser since there are precedents for “special purchasers” to be excluded from consideration where shares in private companies (such as joint ventures) are valued for tax purposes. Where the expression “market value” is used a valuer will tend to think in terms of the definition applicable for tax purposes and apply similar rules, which will not permit them to take into account subjective factors which may influence the price which another person or joint venture party is willing to pay to the exiting joint venture party. Such subjective factors can include the payment of a premium for the shares if it results in the purchaser gaining a controlling stake in the joint venture entity.

In circumstances where the only likely purchaser of an exiting party’s interest in the joint venture is another joint venture party then it will often be the case that “fair value” will be applied as the preferred valuation method. The concept of “fair value” recognises there may not necessarily be an actual market for any third party to buy the shares in the joint venture entity or that an exiting joint venture party has not been permitted to seek a third party buyer.

But we need to be careful here too. This is because if the concept of “fair value” is to arrive at a value which is “fair” to both majority and, more importantly, minority interests then it is crucial the joint venture agreement sets out the factors which a valuer is obliged to take into consideration when determining “fair value”.

At the very least, the joint venture agreement should state that “fair value” is to take into account the following assumptions:

1. valuing the shares to be sold on the basis of an arm’s length sale between a willing seller and a willing buyer;
2. if the joint venture is then carrying on a business as a going concern, on the assumption that it will continue to do so;
3. that the shares or interest in the joint venture to be sold are capable of being transferred without restriction;
4. valuing the shares to be sold as a rateable proportion of the total value of all the issued shares of the joint venture company without any premium or discount being attributable to the class of shares to be sold or any minority interests.

And even if the above assumptions are applied there can often be disagreement on the “fair value” determined by a valuer. In such circumstances joint venture agreements must ensure there is an appropriate mechanism for dealing with and appealing that valuation. In many cases this can be achieved by appointing an independent valuer as agreed between the parties. In the event they cannot agree, the default would be for the Institute of Chartered Accountants in England and Wales to appoint a valuer.
Regulatory Matters

When looking at joint ventures in the insurance sector, the first question from a regulatory point of view is whether or not the joint venture company will be carrying on activities which mean it needs to be regulated. The discussion below relates to business carried on in the UK and if the joint venture company is carrying on business elsewhere, then local rules will also apply.

Some of the key regulated activities in the insurance sector are:

• Effecting and carrying out contracts of insurance.
• Advising on insurance contracts.
• Arranging insurance contracts (and it is important to remember how broad this activity is in that it includes, for example, merely acting as an introducer of business).
• Dealing in contracts of insurance as agent (e.g. under a binding authority).
• Assisting in the administration of a contract of insurance (unless the activities are restricted to expert appraisal, loss adjusting on behalf of an insurer or managing claims on behalf of an insurer)
• Managing the underwriting capacity of a Lloyd's syndicate

There may however be relevant exclusions – for example it is important to remember that general insurance brokers only dealing with large risks contracts of insurance situated outside the EEA are excluded from regulation. Large risks include:

• Railway rolling stock, aircraft, ships, goods in transit, aircraft liability or liability of ships.
• Credit or suretyship relating to a business carried on by the policyholder.
• Land vehicles, fire and natural forces, damage to property, motor vehicle liability, general liability and miscellaneous loss provided the risks relate to business carried on by a policyholder above a certain size by reference to balance sheet, turnover and employee numbers.

If the joint venture company has been set up somewhere in the EEA other than the UK, it will likely be able to passport into the UK to enable business to be carried on here. Otherwise, if the company is carrying on regulated activities in the UK it needs to satisfy the regulatory requirements here.

FSA Authorisation

One option is for the joint venture company to seek authorisation from the FSA in its own right. Another might be to consider appointed representative status which is discussed briefly below. When considering FSA authorisation for the joint venture company in its own right there are a number of issues to think about – this paper deals with just a few.

The first issue is timing. The FSA is entitled to take up to six months to decide whether to grant an application for authorisation from the date when it receives a fully complete application, so time also needs to be factored in for preparation of the necessary information and completion of all the required forms. How long that takes will depend on various things such as the nature, complexity and size of the business. Although the FSA is entitled to take six months, it generally deals with applications in a shorter timescale. It is possible to ask the
FSA to deal with the application more quickly but they are not obliged to agree and it would certainly be unwise to depend upon applications being turned around in the time hoped for. It is of course a criminal offence to carry on regulated activities without authorisation so the joint venture company would not be able to start its regulated activities until authorisation is granted.

Composition of the Board

The company will have to satisfy the FSA that it meets a number of threshold conditions, including that it is suitable, in the sense of being fit and proper. The emphasis is on suitability of the firm itself but the FSA may decide that a firm is not suitable if it has doubts about the individual or collective suitability of persons connected with the firm. So it will look at whether the governing body is made up of individuals with an appropriate range of skills and experience and whether those individuals have been, for example, directors or concerned in the management of companies that have gone into liquidation.

Further, where the joint venture company is carrying on general insurance intermediary business there is a specific requirement to ensure that a reasonable proportion of people in the management structure and all people directly involved in the insurance broking demonstrate sufficient knowledge and ability and are of good repute.

Anyone carrying out a controlled function within the joint venture company will need to be personally approved by and answerable to the FSA as an approved person. Controlled functions are currently (the odd numbering is because some have been recently deleted):

1. Director
2. Non-Executive Director
3. Chief Executive
4. Partner
5. Director of unincorporated association
6. Small friendly society
8. Apportionment and oversight
10. Compliance oversight
11. Money laundering report
12. Actuarial
12A With profits actuary
12B Lloyd's actuary
28. Systems and controls
29. Significant management
30. Customer

Their relevance will vary depending on the nature of the business but at the very least everyone on the Board, whether executive or non-executive, must be an FSA approved person. As directors are often nominated by one of the parties to the joint venture, a director may find himself facing a conflict between the interests of the joint venture company and the interests of the party who nominated him. This is a general issue in joint ventures but a particularly important area of concern for directors of FSA authorised companies - because added to the mix is the fact that they are also FSA approved persons in respect of the joint venture company making any conflict situation all the more stark.
The FSA is proposing to introduce from September this year nine new controlled functions (to some extent reinstating functions it deleted previously):

1. Chairman
2. Chairman of risk committee
3. Chairman of audit committee
4. Chairman of remuneration committee
5. Senior independent director
6. Parent entity significant influence function (SIF)
7. Finance function
8. Risk function
9. Internal audit function

Perhaps the most interesting is the parent entity SIF. In July last year, the FSA extended the controlled functions of director and non-executive director to individuals employed by a parent undertaking or holding company likely to have significant influence over an authorised firm. It applied only where the parent or holding company was not authorised by the FSA or an equivalent elsewhere in the EEA. The intention now is to separate out these individuals and identify them separately under this new controlled function heading. It will apply to anyone whose influence over an authorised firm is comparable to a director or non-executive director and whose decisions are regularly taken into account by the firm’s Board. The scope is being extended so that even individuals employed by an FSA-regulated parent company, who previously fell outside the requirements, will now have to seek approval as a parent SIF for the subsidiary too.

**Close links/Controllers**

If the joint venture company has close links with another firm, the FSA will need to look at those firms (including for example their regulatory regime if they’re overseas) to satisfy itself that those links are not likely to prevent effective supervision by the FSA. Close links is defined widely to include not only parents but also subsidiaries of the applicant company and also other subsidiaries of the parent.

Suitability of **controllers** of the joint venture company will also be specifically considered by the FSA as part of the application process. Controllers include anyone who:

(a) holds 10% or more of the shares in an authorised firm;

(b) is able to exercise significant influence over the management of an authorised firm by virtue of his shareholding in the firm;

(c) holds 10% or more of the shares in a parent undertaking of the authorised firm;

(d) is able to exercise significant influence over the management of a parent by virtue of his shareholding in the parent;

(e) is entitled to exercise or control the exercise of 10% or more of the voting power in the authorised firm;

(f) is able to exercise significant influence over the management of the authorised firm by virtue of his voting power in the firm;
(g) is entitled to exercise or control the exercise of 10% or more of the voting power in the parent; or

(h) is able to exercise significant influence over the management of the parent by virtue of his voting power in the parent.

That can take in a large number of controllers going up the chain of ownership, whether corporate controllers or individuals or sometimes trusts. Forms need to be completed giving details about all of those entities and submitted with the application to the FSA.

**Remuneration**

This is of course a rather controversial area at the moment. It is of particular concern for large listed companies but the FSA has made it plain that it expects all regulated firms to take on board its concerns about remuneration structures, in particular matters such as calculation of bonuses and structure of entitlement to longer term incentives such as share options.

**Capital**

Obviously, there are capital adequacy requirements for regulated firms that must be met on day one (based on projected business) and at all times thereafter. These requirements will determine the amount of capital needed by the joint venture company and also, importantly, the form that capital will take (whether types of shares or other forms of capital) to ensure FSA requirements regarding capital adequacy are met. The structure of dividend payment rights for example also need to take these rules into account.

**Lloyd's**

If the company is going to do business at Lloyd's, there is also the Lloyd's regulatory approval process to go through on top of the FSA requirements. For example, Lloyd's indicates that a new managing agent usually takes between three and five months to set up from first enquiry to beginning underwriting. Lloyd's will look at some of the same things as the FSA but from its own perspective. Again, this will include the quality of staff, and Lloyd's has its own requirements for the composition of a managing agent’s Board.

Remember also that any company intended to act as a Lloyd's coverholder is likely to require approval by Lloyd's under the Delegated Underwriting Code of Practice. There are distinctions between approved coverholders and restricted coverholders which are beyond the scope of this paper.

An alternative type of arrangement is a Lloyd's consortium arrangement where one managing agent delegates authority to another managing agent to enter into contracts of insurance on its behalf. Consortia have to be registered with Lloyd's each year but aside from this, there is no need for approval from Lloyd's to operate a consortium where a managing agent acts as coverholder – unlike a third party consortium manager who would need to be approved as a coverholder by Lloyd's.

If the joint venture company is regulated there will be ongoing issues to consider.

**Appointment/removal of directors**
With regard to rights of shareholders to remove or appoint directors, it is important to remember that if removing a director, the FSA needs to be informed. More significantly in terms of practicalities and timings, any replacement needs to be approved. Generally, a person must be approved before taking on any controlled function (although there are 12 week emergency provisions to deal with reasonably unforeseen situations and temporary absences). The FSA is allowed three months from the time it receives a properly completed application to consider it and come to a decision on whether to approve the person although it is generally dealt with more quickly than this, in a matter of weeks rather than months for a straightforward application.

Lloyd's also has requirements for notification of proposed appointments to senior positions – before an application is sent to the FSA.

**Changes of Control**

Changes of control (for example where one joint venture party wants to buy out another) also require prior approval of the FSA.

Anyone who proposes to acquire or to increase control over an authorised firm has to notify the FSA in advance and obtain approval. (Reductions of control only need to be notified). If someone acquires or increases control without taking any step himself then he must notify the FSA within fourteen days of becoming aware of the facts.

Acquisition of control is determined in accordance with the definition of control set out above. Relevant increases in control requiring approval are in four bands:

- From below 10% to 10% or more but less than 20%;
- From below 20% to 20% or more but less than 33%;
- From below 33% to 33% or more but less than 50%;
- From below 50% to 50% or more.

In determining whether a threshold has been reached, it is necessary to consider not just the controller itself but also the controller together with its associates, including directors and subsidiaries for example.

The FSA has three months in which to determine whether to approve someone becoming a controller or increasing control. Failure to notify the FSA of a proposed acquisition or increase of control is an offence. It is also an offence to go ahead during the three month period before the FSA confirms approval.

Prior notification must also be given to Lloyd's for a proposed change in control again before the application is submitted to the FSA.

**Appointed Representative status**

A possible alternative to the joint venture company becoming an authorised person in its own right is to consider the company becoming an appointed representative of an authorised person. That might be one of the joint venture parties if they are FSA authorised themselves. Appointed representative arrangements are only available for certain regulated activities – which do include general insurance intermediary business.
There are some very real benefits to an appointed representative arrangement. There is no need to make an application to the FSA and little time lag. What is required is for a written agreement to be entered into between the authorised person making the appointment (the principal) and the appointed representative containing as a minimum certain FSA prescribed terms. The FSA must be notified of the appointment and put it on the FSA register.

It is also possible for a principal to make someone an introducer appointed representative (IAR) which is a limited appointment allowing the IAR only to make introductions of business to the principal or other members of its group and to distribute certain promotional material.

For the principal, the issue is that it becomes responsible for the activities of the appointed representative. The FSA has various rules designed to place responsibility on the principal to ensure that its appointed representative is fit and proper to deal with clients in the principal’s name and that clients dealing with the appointed representative get the same level of protection as if they had dealt with the principal itself.

There are obligations on the principal to take certain steps to vet the appointed representative at the outset for issues such as solvency and suitability. Disciplinary history and details of the appointed representative’s directors, senior managers and controllers should be considered. (The vetting requirements are generally less onerous for an IAR). The principal must also make sure that it has adequate control over the appointed representative’s regulated activities and the resources to monitor and enforce the appointed representative’s compliance.

Approval of the appointed representative by the FSA is not required per se. The FSA may consider whether it has any intelligence information about an appointed representative that is of concern (which may be unlikely with a new joint venture company) and if the appointed representative is carrying on insurance intermediary business the FSA does specifically have power to refuse to include it on the register – or to remove it and thereby put an end to the appointment – if the FSA does not believe it to be fit and proper. But generally, because an appointed representative is not authorised in its own right, most of the issues highlighted above regarding regulation of authorised firms will not arise, making it worth considering in at least some circumstances.

29 July 2010