



SANCTIONS UPDATE

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States Use Insurance Regulations to Target Companies Doing Business in Iran

Insurance companies licensed to do business in U.S. states have become the latest target of state efforts to encourage divestment from non-U.S. companies that do business in Iran. On February 10, 2010, the California Department of Insurance **announced** that as of March 31, 2010 insurers will no longer be able to count their investments in certain companies doing business in Iran toward their capitalization and surplus requirements. The California Department of Insurance is also asking insurers to refrain from making future investments in these companies. It is unclear whether these measures, if challenged in court, would be determined to be constitutional.

Developments in California

California law requires insurers to carry a minimum level of capital and surplus to be licensed to sell insurance in that state. Insurers employ multiple strategies to satisfy these requirements, including by investing in non-U.S. companies. The California Department of Insurance is now limiting the range of non-U.S. companies whose securities can be used by insurers to satisfy state capitalization and surplus requirements, based on the view that investments in certain non-U.S. companies are subject to enhanced financial risk stemming from their business in Iran.

The Department has published a **list** of 50 non-U.S. companies doing business in the Iranian oil and natural gas, nuclear and defense sectors whose securities and other investment instruments will no longer be recognized by California on insurers' financial statements as of March 31, 2010. The Department developed its list based in part on a review of lists developed by the public pension funds of **California, Florida and New York**, which have also implemented divestment-related measures. The Department will also refuse to recognize investments in entities in which a listed company has a 50 percent or greater ownership interest, although it is unclear how the Department and insurers will identify such entities.

The elimination of statement credit for investments in listed companies and their affiliates means that affected insurers will be required to reduce the capital and surplus reported on their financial statements by the amount of their investments. Of the 1,300 insurers licensed to do business in California, the Department reports that about 340 hold investments in listed companies. Those investments total approximately \$6 billion.

The Department also has requested that all insurers licensed to do business in California agree not to make future investments in listed companies, or in entities in which a listed company has a 50 percent or greater ownership interest, until the company is de-listed or Iran is no longer identified as a state sponsor of terrorism by the United States. The Department has indicated that it may publicize the names of insurers that decline the Department's request for a moratorium on future investment in listed entities and their affiliates. Two unnamed insurance companies reportedly already have agreed to divest their Iran-related investments in response to the scrutiny by California regulators. Negotiations concerning divestment are also apparently ongoing between the Department and several other insurers.

The Department has indicated its intention to continue investigating entities that do business in the Iranian petroleum and natural gas, nuclear and defense sectors, with a particular emphasis on bank involvement. If the Department expands its list of targeted companies to include such entities, the impact of the new California measures on insurer capitalization and surplus strategies could be significant.

Toward a National Trend?

The impact of the new California measures could also be amplified due to their influence on insurance regulators in other states. For example, the Commissioner of the Florida Office of Insurance Regulation has strongly **supported** California's measures and called for their broader implementation. The Florida Commissioner has reportedly already contacted other state insurance commissioners about this issue. Further, in his capacity as the secretary-treasurer of the National Association of Insurance Commissioners (NAIC), the Florida Commissioner has reportedly contacted the NAIC's Securities Valuation Office to determine the feasibility of reviewing the exposure of national insurers to companies with operations in Iran.

The possibility of a national trend may be of concern to insurers, which must satisfy state capitalization and surplus requirements, as well as to the non-U.S. companies targeted by insurance regulators, which may find their access to U.S. capital markets inhibited. However, the impact of such potential state measures may be reduced by the fact that these measures could be found unconstitutional if challenged in court. At least one federal court has held, based on U.S. Supreme Court precedent, that state and local divestment measures undertaken for foreign policy reasons (in that case involving Sudan) infringed on the federal government's exclusive power over foreign affairs. It is possible (but by no means certain) that other courts could reach similar conclusions with respect to state insurance measures that encourage divestment from companies doing business in Iran.

It is also possible that the U.S. Congress could adopt legislation authorizing state insurance measures encouraging divestment from Iran. For example, the U.S. Congress ultimately cured the constitutional defects of the state and local divestment laws targeting Sudan by enacting the Sudan Accountability and Divestment Act. This act expressly permits state governments to enact divestment measures with respect to Sudan, subject to certain requirements. With respect to Iran, the U.S. Senate approved legislation (S. 2799) earlier this year which includes a similar authorization for state and local divestment measures. While this authorization would not cover insurance-related divestment measures, the legislation is subject to change as it is reconciled with a related measure approved by the U.S. House of Representatives.

In short, the broader impact of the new California measures remains to be seen. For now, insurers should consider reviewing their investment portfolios to determine the likelihood of future scrutiny by state regulators. Non-U.S. companies doing business in Iran, directly or through affiliates, should assess the likely impact of divestment-related state insurance measures on stock prices, capital availability and corporate disclosures.

If you have questions about any of these items, please contact your regular Sidley Austin LLP contact.

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