

# RECORD OF SOCIETY OF ACTUARIES 1977 VOL. 3 NO. 1

## ACQUISITIONS, MERGERS, AND NEW EVALUATIONS

*Moderator: WALTER S. RUGLAND. Panelists: STEPHEN D. BICKEL,  
THOMAS P. BOWLES, JR., GAYLEN N. LARSON\*, THOMAS A. PLAYER\*\**

An interdisciplinary examination of techniques, considerations and methodology associated with evaluation of acquisitions, mergers and new ventures.

It is intended primarily to consider the investment, legal, tax, accounting and actuarial aspects of externally directed activities, although internally directed activities (e.g., new lines, synergistic adventures, holding companies) may also be addressed.

MR. WALTER S. RUGLAND: We've decided to utilize a case study approach today in order to elicit some practical discussion about some real aspects of corporate planning. We've tried to create a situation that is easy for the audience to comment on and to ask questions. In addition, such an approach puts all of our panel members, which includes two non-actuaries, at a common starting point.

### A. Situation for Discussion

The Hilbert Tool Company is the base corporate entity of a sizable U.S. Holding Company specializing in agriculture centered equipment manufacturing, retailing and servicing. Its stock is the home grown favorite of traders on several regional exchanges, even though Hilbert Coward controls 20% of it.

The financial press attributes Hilbert's success to his tight management. "I learned as a farmer to keep control of controllables." Coward says, "The weather risk was a tough enough unknown."

Coward demands results from every unit on a rigid measurement basis which varies among units, depending on the risk index he applies to the capital committed. Historically the earnings growth has been steady, reflecting the aggregate objective of an annual 15% after tax return on capital for the entire entity.

Hilbert's market researchers have presented a report to its executive committee advocating expansion into financial services for the agricultural community. A life insurance company has been suggested as the initial step. Several marketing approaches are suggested but the recommended one utilizes all Hilbert facilities

\*Mr. Larson, not a member of the Society, is a partner with the firm of Haskins and Sells, Inc., Chicago, Illinois.

\*\*Mr. Player, not a member of the Society, is a lawyer with the firm of Neely and Player, Atlanta, Georgia.

as prospect sources, requiring a face to face meeting to close the sale. The marketing group is confident that Hilbert's marketing expertise and reputation will bring sales success in this activity.

"But will it bring adequate profits?" asks Coward.

He authorizes a special committee to obtain appropriate counsel and provide an answer to that question.

In its initial meetings, the committee agrees to retain actuarial, accounting and legal assistance. It also determines that its initial report should be based on the premise of obtaining an existing company with a sales operation of sufficient size to enable face to face selling.

(The assignment to the panelists is to outline their contribution to the committee report and to be prepared to answer the query "But will it bring adequate profits?")

It was obvious to the panel members when they first read this case that there just aren't enough facts here. But we agreed that this was real life. When you become involved in situations like this, you rarely have all the facts you would like. Let's hear the panel members' comments on this case.

MR. STEPHEN D. BICKEL: According to Hilbert's definition, an adequate profit is an annual 15% after tax return on capital. In order to achieve this result immediately, you would need to pay a price of about seven times the earnings which you expect that company to report after the purchase.

The first problem I see is that the earnings that the company has been reporting, even if they are on a GAAP basis, are not necessarily an indicator of the earnings which will be reported after the purchase. The earnings after the purchase will be effected by all the purchase accounting adjustments required by APB-16. These require all the assets and liabilities to be adjusted to the current "fair values", and any excess of the purchase price over the book value acquired is to be labeled goodwill and amortized over a period not exceeding 40 years. If you pay \$30 a share and the book value is \$25 a share, goodwill amortization would reduce future earnings by 12½ cents per year on a 40 year straight line basis.

If bonds and mortgages are reduced from their current book value to market value, investment income after the purchase will be increased, which will result in higher earnings than the company would have reported on its own basis. On the other hand, the reserves should be adjusted to current assumptions as to mortality and interest and this reduction in reserves at the time of the purchase will mean higher reserve increases and lower earnings after the purchase.

Deferred tax credits are to be eliminated from the balance sheet, but that should not affect future earnings.

One convenient technique for measuring these items is to assume they all offset each other. However, this technique may be too fast and loose for a tight manager like Mr. Coward. Another technique may be to examine the balance sheet to see if a fairly good match exists between the reserve liabilities and certain assets which are being reported by book value. If the yield on these assets is close enough to the required interest on GAAP reserves, it may be reasonable to estimate that the purchase accounting adjustments on these assets and liabilities may offset each other. In that case you would only need to adjust the remaining assets to market to estimate the change in values which may occur.

Of course, the job can be done quite precisely by hiring a team of consulting actuaries and sending them out to the prospective company to revalue the business. However, this may not be a practical solution.

An easier technique is to get a copy of the company's ratebook and do some gross premium valuation work with some of the principle plans. From this, you may be able to get a rough idea of the amount of the adjustments.

The technique I prefer in this situation has been called the "defined valuation premium method" of determining reserves in purchase accounting situations. This method is described in Gary Corbett's paper in the "Transactions" as well as Bill Odell's paper in the "Proceedings" of the Conference. It will be published as Interpretation 1-D of the Academy of Actuaries Committee on Financial Reporting Principles. Under this method, the reserves are determined by a gross premium valuation, holding back a specific profit margin deducted from gross premiums such as 5%, or 10% say. The percentage should be in line with the profit margin you expect to achieve for new business issued in this company.

The next step after determining the purchase accounting effects, is to estimate the changes in earnings which could occur as a result of the purchase. It may be there are some expense economies which can be immediately achieved, such as discontinuing the development of markets which are inconsistent with the new desired approach. The life company may be able to become insurer for fringe benefit plans for Hilbert's employees. It may be possible to change the company's investment strategy. It may be advantageous tax wise to contribute surplus into the company.

The chief earnings improvement will probably come from business which the tool company expects to create for the life company. The measurement of these earnings can be done by a model office projection. The projection should illustrate Statutory and GAAP earnings before and after Statutory and GAAP taxes, assuming different levels of production and profitability. It seems likely to me that Hilbert will not be able to realize the 15% return on capital very soon. Developing the marketing system may require significant initial expenses which cannot be amortized in the GAAP reserve process.

While the company will have an existing field force, or is assumed to, it is possible that these agents will not be suited for the market that Hilbert has in mind, so it will be necessary for Hilbert to recruit new agents, presumably using the existing sales management. It may be necessary to develop new ratebooks and field compensation systems in order to build the desired marketing team, and since the marketing approach is new and untested, it may be necessary to try different alternatives before a successful technique is developed. Hopefully, this type of projection will point out to Hilbert some of the problems which need to be overcome.

Mr. GAYLEN N. LARSON: As an independent accountant, and I am sure that at least one of the others on this panel feels the same way I do, I think I would back off from the approach that Steve just talked about and ask some more basic questions before we get that far down the line.

First of all, Steve assumed the use of a purchase accounting method. He didn't discuss whether or not we could use the pooling of interest method. Perhaps that was a realistic assumption because we seldom see poolings these days. The accounting principles have been tightened significantly, and a basic question to consider before jumping into purchase accounting is "Is that the method we will have to use?" The other method is a pooling of interest where we continue to use the same accounting bases, etc. as was used previously. This alternative is worth considering early in the acquisition review.

But I would even back up further. Before I could begin to be helpful to a client, and I am sure before any outside consultant could, we would really have to know more about why he wants to buy this business. What is his real purpose? You can't possibly make an intelligent valuation without knowing that. I would certainly concentrate on trying to analyze the reasoning behind the purchase. Then this reasoning should be used to evaluate the potential acquisitions.

MR. THOMAS A. PLAYER: I would agree with Gaylen that as an attorney walking into a situation like this there are many things you want to find out. I think you probably know that there are many alternatives for making a combination such as this. The thing I would ask Coward is, "Do you know what you are getting into from a legal point of view?"

One aspect of an acquisition that I would like to briefly talk about is the Insurance Company Holding Act. Generally, either through states adopting this Act, or through reciprocal agreements between states you are going to have to file under the rules set forth by the Act. Many attorneys who are not familiar with insurance acquisition, but who are familiar with business acquisitions in general, seem to take this Act too lightly.

They say, "This isn't too tough, we'll wait to do that last."

Let me tell you some of the pitfalls. One pitfall is that under the Insurance Company Holding Act, the acquisition has to be fair and reasonable. This refers to the shareholders and policyholders. What does that mean? I don't know what it means. I don't know that anybody knows what it means! But, the insurance departments of the respective states want to know, "Is it fair and reasonable?" Also, they want to know how you arrived at the values. The fact that it was a negotiated transaction is not good enough.

About four years ago, we were involved in a transaction and said to an insurance department, "Well, the parties negotiated among themselves and this was the negotiated price." That wasn't acceptable. We had to show the pieces, how they fit together. We really had to reconstruct a fantasy and present it, and we finally got them to see that through a combination of factors we arrived at a negotiated price.

Regarding the fairness and the reasonableness of the transaction, I found insurance departments wanting outside verification of fairness and reasonableness, and this goes a long way. Suppose you're a consulting actuary, or perhaps an in-house actuary, or an accounting firm, or an investment banker, and the company comes to you and says, "I want you to just take a look at this and give me a letter that you think it is fair and reasonable." I would think long and hard about giving such a letter, because you are verifying to the policyholders and the shareholders that it is fair and reasonable, and the attendant liabilities can be outlined very forcibly by Gaylen. And the way accounting firms go, so go the law firms, and perhaps actuarial firms.

I think the bottom line is that if you are engaged to do this, find out for whom you are working. If you are working for the Board of Directors, then I would suggest strongly an engagement letter from your firm to the Board, outlining the scope of your involvement, the recommendations you are making, and that you understand that you are working for the Board of Directors to support their findings as to the fairness and reasonableness of the transaction. Because, in the ultimate, the Board of Directors is responsible for the acquisition.

I would also strongly urge you to limit the distribution of the letter; say the report or letter is for your use only, and any distribution of it shall be with the expressed consent of the firm. This includes the filing with the insurance departments, because you can file in a confidential manner. In the holding company publication to the shareholders of the acquired company, a note will be made that the fairness and reasonableness of the transaction has been attested to by an outside consulting firm, period. Now that's better than naming your firm.

Also, I think it is much better if nothing is mentioned if you are doing a prospectus for a proxy statement. The Securities and Exchange Commission (SEC) will require that the name of the firm be included in the proxy material if they feel an appraisal has been made, and then you are in the soup, because you are an expert and your name as an expert is found in the material filed with the SEC. Then, I think you have 10B(5) responsibility.

MR. THOMAS P. BOWLES, JR.: I agree with what Gaylen has said. The obvious reaction of any consultant who looks at this case is that we don't have enough facts. Of course one is always facing the danger of reaching conclusions that are derived from his own experience. My first reaction was to tell the company they ought to employ a new firm of market researchers.

I reached that conclusion based on my experiences as a member of the Board of a large conglomerate which does not have any insurance companies in it, but one of our major components is a manufacturer of farm related equipment. Knowing from my experience with this particular company, if a market research firm said, "You should go into the financial services business to capitalize", I would say they ought to have their heads examined, so that's a conclusion one reaches when he goes back into his own experience.

I think this is an excellent opportunity for the actuaries present, whether they be consulting actuaries or in-house actuaries, to take a close look at what is really the responsibility of a professional actuary in a situation like this. First of all, as Gaylen has said, we think that you should not accept an assignment such as this case suggests without really going back into the case and taking a look at some of the basic questions. For example, we would like to know why the market research firm recommended that they expand. Specifically, we would like to know why they recommended Hilbert expand into the financial service business. Without a knowledge of what the purpose of this acquisition is, we think any consultant is at a loss to give adequate professional advice to his client.

Now, there are some sleepers in this, of course, and I would like to suggest two of them. One is the question, "Can we achieve an adequate profit?" Well, we have to define adequate profit! No one can answer the question unless he knows what in the mind of the client is in fact an adequate profit. Another sleeper that's raised is that if we presume we can do it, how do we do it in the life insurance business?

Let's go back to the first question, "Why do we want to expand into this business anyway?" Let me suggest several reasons which we would like to explore with the client in order to have a good feel of what our advice to him should be. First of all, is he doing this principally to increase earnings per share or to increase earnings just in total? He is doing it to capitalize upon a presumed preferred market to which he can offer a new product. The example says that he has a distribution system, so presumably there is a delivery system which he can lay hand on and use that delivery system to deliver another product and increase his earnings. Is he doing it to increase the return on his invested capital? The case says that he expects, and has been achieving, a 15% return on his invested capital. If he wants to increase the total, he's got to go more than 15%. If he is satisfied to remain at 15%, he's got to achieve at least that on the new venture. If he is willing to achieve less than 15% on the new venture, which he may want to do under the circumstances, then his return on invested capital in total will come down.

Another question we would like to ask is "Are you doing this principally to stabilize earnings?" because this would perhaps in part determine the type of business that we would suggest that he sell. Is he doing it to provide opportunities for his management to have room for growth and development? Or, is it simply a recognition on his part that he has an obligation as an entrepreneur to respond to the opportunity of delivering to the public products which he perceives are needed by them?

Then, I suppose, we would get down to other basic questions as we begin to take a look at the numbers in the economics of the proposal. What are the markets that the market research firm has referred to, and what are the products that they perceive would be offered or that they perceive are the desirable products for this effort to offer to the consumer?

So there are just all kinds of questions we would want to know the answers to. Now, we submit to you, the actuary, that when you are called into a situation, whether it be by your employer or by your client, you should not confine your attention to just the narrow framework that would be involved in answering the specific question. If you do, you will be doing it, as Gaylen said, in a vacuum, and you cannot render good, professional advice to any client or to any employer if you are looking at the particular situation solely in a vacuum.

There are a couple of other questions we want to know the answers to. We want to know the magnitude of his human and financial resources that he can commit to such a venture. This is a logical question to ask him. We would also want to know what control and management monitoring technique or mechanism would he impose upon this operation, because that would affect our answers. We want to know whether or not he is satisfied with the profit level which will have been defined and then we would ask him this question, "You say you want to buy a company, do you really want to buy a company? Would you be better off if you organized your own company?" It is easy for the actuaries to find a broker and help locate a company, but really Coward ought to have his attention directed to a very basic question, "Would you really be better off if you organized your own company, so you wouldn't be saddled with an existing delivery system which might not be consistent with the way you want to deliver your product?"

I would like to ask Tom Player a question. Tom, I know you've had considerable experience in the area of insurance acquisition cases. How do you appraise, in this whole program of acquisition and expansion and so forth, the interdisciplinary interplay of the actuary, the accountant and the lawyers?

MR. PLAYER: An insurance acquisition is not like a manufacturing company, where you can test the water and find out what's there. What happens is that first of all the Chairman of the Board has lunch with the Chairman of the Board of the other company and he finds out some pertinent information. Then, the Senior Vice Presidents have lunch, and the target company Senior Vice President delivers unaudited financials for the last month which show that they are really on the right track. The Chairman of the Board sees this and calls in the Marketing Vice President. The Marketing Vice President has lunch with their Marketing Vice President. Their Marketing Vice President says, "We are going in to New York state; no question about it, we've got the approval." The final piece of the puzzle is that the attorney is called in and is told, "We've got a deal, draw it up."

What happens is that the structure of the transaction rests squarely on hearsay, and you can warrant and represent all you want as to the Statutory financial statements of the acquiring company or the GAAP financial statements, or both, but you won't get the underpinnings of the transaction. One duty of the attorney is to find out on what basis the transaction was negotiated, and the best way to do that, that I have found, is to get up a centralized source of information where all information from the target company is routed and receipted for. Now the attorney, when he does the acquisition agreement, can negotiate for warranties and representation as to the correctness in a material sense; you can have slippage but the material correctness of the information upon which the negotiation was made is essential.

Also, in the first meeting or very close to the first meeting, if there is a letter of intent, I think it is very important to include that the acquiring company will require the standard representations and warranties, and you can leave it like that. That puts them on notice that they are going to have to abide by the work, written or financial, and that's very important. There are problems in enforcing those warranties and representations, but if you have them it is much better than if you don't.

MR. LARSON: I think that the idea of having warranties is excellent. They can protect everyone involved and, if I was the attorney, I would certainly feel obligated to ask for these. An experience which I have had on many occasions, however, is that the process of acquiring and agreeing on detailed warranties can defeat an acquisition agreement.

Tom's point about putting them on notice is also important. As a practical matter, there are times when you just can't get all of these warranties and notices.

Another idea I might throw out at this point is one of developing a timetable. As we have said, a key point to learn is the "why" of an acquisition. After that, if you are going to have a decent chance of a complex merger being executed successfully, it is important to develop a timetable with each party involved identifying their individual responsibilities (what and when?). It is amazing to observe the many acquisitions that become fouled up because a basic timetable was not developed and followed.

MR. BICKEL: I think by far the best thing the company has done here is to form this committee, because with an actuary, a lawyer, and an accountant they are going to cover an awful lot of problem areas. I think the idea of buying a simple corporate shell or forming their own corporation is probably more suited to what Coward has in mind than to buy a company with an existing field force. The markets they intend to work in are unique enough that they would probably be better off forming their own shop, getting themselves a good President for the company, and building from scratch.

Earlier, Tom was talking about the Holding Company Acts. The problems of getting approval there are quite significant. One problem is that these acts are fairly new and the personnel in the insurance departments don't have much experience in applying them. To explain why a particular price is a fair value you must start talking about GAAP, for example, instead of Statutory. In our company we've eventually succeeded in every case, but in one case, we did have to increase a price above that which we negotiated with the other company in order to get holding company approval.

One other risk that hasn't been mentioned yet is that the Hilbert Company is pretty successful now and it is mentioned that the stock is the home grown favorite of traders on several exchanges. Sometimes, when a non-insurance company will make an offer for an insurance company, the market response may indicate that this is not the business that Hilbert ought to be getting into. Occasionally, companies have made offers and then had to retract because of the adverse market response.



MR. LARSON: Steve, I would like to address purchase accounting for a moment. It was stated that you would have to justify, to some degree, to state insurance departments whether or not the price to be paid is reasonable. I think it is important to discuss at this point what we in our profession know as fair value accounting. Fair values are not necessarily intended to be used to establish the purchase price. They are intended to value assets and liabilities for accounting purposes. In other words, to allow the acquiring company to account for them in their balance sheet and in future income statements. How do these items affect future financial statements? Steve mentioned that all net together or offset to some degree. In many ways this is true and no matter what you do in that fair value determination, the only significant effect will generally be on future profits as to the timing. In other words, the accounting period that debits and credits will be reported in the income statement will be changed but the total profit to be earned from the business over an extended period of time may not be changed.

As an example, let's assume that we write off all of the deferred expenses or some other account. Let's say that we have debit goodwill, and we make a judgment that profit should be seven percent of premiums, as opposed to 15 percent that the company is actually earning. You then go through the motions of calculating fair values and goodwill. Since goodwill must be amortized, the only effect of these adjustments of future income statements will be a change in amounts reported in certain periods by changing them to different periods or by identifying them differently. In this case, writing off a deferred asset that would be expensed in future periods increases goodwill by an equal amount and that will be written off in some future period also.

Therefore, I think it is important not just to look at the accountant's determination and believe that their method is the fair value which should be used to determine the purchase price to be paid. What you really have to determine is why is the company making this acquisition and then trying to look at the situation strictly by focusing on the values to be acquired and the ability thereof to meet the purchaser's requirements.

It is amazing how many times historical accounting cannot be used to reflect future values. We all know that historical depreciated cost values of real estate cannot be relied on to be an indicator of their current or future values. Further, an insurance company may have an agency force but the future value of that asset is unidentifiable as far as I am concerned. I am perfectly content to classify any such value of an "unidentifiable intangible asset" as goodwill. After all, the intent of the goodwill account in my mind is to measure the difference between the worth of the business in the acquirer's mind (or the amount he was able to purchase it for, if that is different) and the value of the tangible and identifiable intangible assets acquired net of the liabilities assumed.

MR. BOWLES: Gaylen, are you saying that the GAAP earnings to emerge in the future on the purchase accounting are not significant in determining the purchase price?

MR. LARSON: I am saying that earnings are significant in the way they emerge in the future, but that I believe the purchase price should not be determined by looking at tangible assets and liabilities calculated using market values, present values, etc., without making a more deep evaluation of the future worth of the business to the buyer.

MR. BOWLES: Once those emerging GAAP earnings under the purchase accounting have been displayed before the acquirer, it is possible that he might decide not to make the deal because it will decrease his earnings per share, and he doesn't want that. That's a possibility, right?

MR. LARSON: Yes.

MR. BOWLES: One other comment, Tom Player has talked about the warranties problem, and Gaylen or Steve are talking about money as the problem. I would suggest to you that the problem which really aborts more acquisitions and mergers and deals like this is the people problem; not money, not warranties, but the people problem.

We've seen a very fine highly desirable acquisition merger fall through because the Chairman of the Board, a Board of a giant company, refused to put the President of the to be acquired company on this Board. The deal was fine for everybody. A beautiful deal for everybody but it fell through because he wouldn't put him on this Board. . . a people problem.

A few years ago we were called in by a group of small mutual companies to monitor their discussions about the merit of getting some of the smaller mutual companies together, and we sat through the whole day (and as is not usually customary with actuaries, we were quiet the whole day and listening), and towards the end of the day one of the astute gathered brethren said, "Well, you haven't said much, what is your appraisal of our position?" I said the same thing you would say, "What you are talking about makes a lot of sense but it seems to us that you really haven't come to grips with the very basic problem. Who is to be President, and where is the home office going to be?" Thereupon they packed their bags and they dispersed to various parts of the country. So it is the people problem, and I would alert you to that if you are involved. Don't overlook the people problems!

MR. PLAYER: (In response to a question from Mr. David M. Welsh.) Yes, we have run into antitrust problems in the acquisition area. There is a struggle going on now as to whether or not the McCarren-Ferguson Act applies to life insurance mergers. This Act states that in the business of insurance, the states have preempted the Federal government in the regulation of insurance. All states that I know anything about have antitrust provisions in their state insurance laws. In the American General case in 1974, American General was trying to get an injunction against the FTC, the Federal Trade Commission, from stopping a merger. The District Court in Texas and subsequently the 5th Circuit said that the business of mergers between insurance companies is not the business of insurance, and further even if it is, the states cannot extraterritorily regulate the impact on the competitive areas outside of their states.

As far as Title VII of the Act, which is the teeth of the antitrust legislation applying to insurance, I think it is an open question. I do know that in a case where a holding company (of which I am somewhat familiar) was to acquire a Washington, D. C. based company, the FTC and the Justice Department moved to block that acquisition under the Clayton Act.

The Justice Department wants to eliminate the immunity for insurance companies. A task force set up by President Ford in 1974 on antitrust immunities, reported that the business of insurance should not be immune from Federal antitrust laws. It said the logical answer is that we should all get behind Senator Brooke's bill on Federally chartered insurance companies, which is an option that if you have a Federally chartered company, you fall under Federal antitrust regulations. Senator Brook's bill is going to come up again this year.

MR. BICKEL: I can add a little bit about the American General case that Tom mentioned. This involved the Fidelity and Deposit of Baltimore. To give you an idea of what catches the government's attention, Fidelity and Deposit was, prior to the acquisition, the second largest writer of fidelity bonds and third largest of surety bonds or vice versa. That in combination with the bonding business of our companies would make them first in both categories, and this appeared to be in violation of the Justice Department guidelines. The case has not been resolved. There was a decision that the antitrust laws could apply, but it has not been concluded yet whether or not they were actually violated in this case. The investigations have been appealed and dragged on for five years or so and we have indicated our intent to appeal any adverse decisions as far as we can. At the worst we might have to sell one or more of our companies, and presumably this can be done on a profitable basis. Apparently, five years is a short time in an antitrust case. We have not, in the meantime, actually merged the operations as far as pricing and so forth. The companies have been kept entirely separate.

MR. LARSON: (In response to a question from Mr. Gary Eckard.) To explain the determination of goodwill with respect to the development of book value would take much longer than this session allows. Basically, the accounting concept is to value tangible assets, liabilities, and identifiable intangible assets at market and/or present values.

Identifying intangible assets is something that has been difficult to agree on. Some in our profession believe that the agency force is an identifiable intangible asset. As I have said previously, I have trouble with that conclusion. I think that goodwill includes values such as that and many others. But the profession and industry has not resolved this matter. All other deferred and intangible items in the balance sheet are generally written off for fair value purposes. This includes deferred tax accounts too; however, the tax effect is often merely reassigned to the individual asset or liability involved.

The fair value concept is basically comparable to purchasing a piece of land. If the market value is \$1,000,000 but the tax basis that comes with the asset is only \$500, we obviously have a great disparity in the tax basis. When we sell that property, we are not going to get the full benefit of what we paid for it, so we have to tax effect each individual item. In effect, we are indicating that its value really isn't market because of the taint of not having the full tax basis follow that asset. We are really valuing each asset and each liability on the balance sheet separately; we are relating the separate items to some degree, however. The earnings expected to be generated from the fair valued assets are the earnings that will be invested in the life reserves. Therefore, you are looking at the yield from those assets as a part of your determination of the interest element used to establish fair valued insurance reserves. When you complete the valuation of assets and liabilities, you compare the net value to the purchase price and the difference is goodwill. I realize this is a general explanation but I doubt that this audience wants to go into it any further today.

Another question concerns how we treat policy loans, and that is one that has been handled in more than one manner. My personal preference is to relate it to the calculation of the related insurance reserve using similar assumptions as to life of the loan (as compared to mortality and withdrawals) and to present value the interest assumption based on the difference between the stated rate and the fair value rate used to value the insurance reserves. Of course, it may also be possible to state the asset at historical value and take any possible lower yield into account when identifying the interest rate that will be used to calculate fair valued insurance reserves.

MR. DANIEL A. CAMPBELL: I would like for any of the panel to comment on the special problem involved in acquisitions of insolvent insurance companies and what effect Senator Brooke's bill, including the National Guaranty Fund, would have upon such acquisitions.

MR. BOWLES: I think it is probably a bad deal. Would it be done for tax reasons?

MR. CAMPBELL: It can be done for any number of reasons. Tax reasons are just one. It also should be an additional source of earnings, or an additional source of income to reduce unit costs.

MR. BOWLES: What do you mean by an insolvent company?

MR. CAMPBELL: A company that has been placed in receivership by the state insurance department. The insurance department is looking for somebody to reinsure the business on a block basis.

MR. BOWLES: That is to say the statutory liabilities including capital funds and surplus funds are greater than statutory assets?

MR. CAMPBELL: Right.

MR. BOWLES: Let me ask another question. If the company is insolvent, as so defined, would you say it has an economic value to a buyer?

MR. CAMPBELL: It depends on how you are going to treat this business when you take it over. One way to do this is to place a moratorium on the cash value of the policies in order to reduce the liabilities to be equal to the assets so it won't be a surplus drain upon the company that is reinsuring the business.

MR. BOWLES: Let's go to the extreme and say here is a company that's not insolvent statutorily as you have defined it. Let's suppose it has a premium income of \$10,000,000 a year, of good ordinary business. That has a capital and surplus fund, and if you are making a determination of the value of that company, you could pay cash for it. Just to simplify it, let's leave out stock. You want to pay cash for it.

You would probably do something like this. You would take its capital and surplus funds and make whatever adjustments you want to convert those values to what reasonable market values you want to apply. Then you would say the business in force, forgetting the agency organization might be worth \$10,000,000 or \$8,000,000 or something if you could just transfer it over. Now, if it becomes statutorily insolvent by a million dollars it has an economic value still of \$9,000,000, doesn't it? So, if you pay \$9,000,000 for it you don't have a question of rehabilitation or putting liens on it

or anything else. That's why I wanted us to get in the open what really is meant by an insolvent company. As you pursued your questioning, you have defined insolvency as being a case where the company is not only statutorily insolvent, but it has no plus economic value. In other words, the excess of liabilities over assets is greater than the value of the business that you take over. By whatever method you use, you are the buyer so you have to make a determination on what you consider to be the value of the business.

MR. CAMPBELL: Restrictions upon the policy provisions change the value of the business; so the value is not a unique characteristic.

MR. BOWLES: I think you've answered your own question. You have placed a value upon the company by whatever techniques you place on it. Then having placed that value, you say the company has this economic value that's negative. You've still got to have something that is the future productivity of the agency organization you take over because you wouldn't pay something for a company that has a negative economic value and just liquidate it and terminate it. You would want the productivity to produce business in the future which would increase that negative economic value to at least a positive or zero, wouldn't you?

MR. CAMPBELL: No, not necessarily. There may no longer be an agency force to take over.

Can I just re-ask the specific question of whether Senator Brooke's bill including a National Guaranty Fund would effectively eliminate such acquisitions? Would there no longer be a need for insurance departments to parcel out insolvent companies to other companies?

MR. PLAYER: No, because we have state guaranty funds that you no doubt are familiar with and that would just be an overlay of a Federal guaranty fund. The real question is in a state guaranty fund, like the one in Washington state. If you were a domiciliary company, having a great deal of premium in that state, and you were going to buy a block of business from a state receiver, I think you would have to weigh your company's share of the losses to policyholders against a reduced purchase price in buying the business.

Let me state it another way. You have a block of business which the state has in receivership. They want to sell, and this is a negotiated transaction. The point is, if you pick up the business at a bargain, and you are a domicile company with a larger premium income in that state, (which is the measure for your contribution to the insolvent company), then you may find that you paid through the backdoor for getting the bargain. I think that's just one example. Senator Brooke's bill, in my estimation, would have no consequence except that it would pick up that same loss to policyholders much like the FDIC does to the back depositors.

MR. BOWLES: I wasn't being facetious in throwing your questions back at you, Dan. I apologize, but I was trying to tiptoe around to something in my experience. We've been involved with a company which about seven years ago determined, as a result of an audit we made of them, that they had liabilities in excess of assets by about \$12,000,000. So, the court put them under a plan of rehabilitation and assessed liens against the policyholders. They continued to pay all death claims and all maturity values, but not cash values. They placed, in effect, a moratorium upon the payment of cash values to prevent a run on contractual obligations. At that particular point in time it had an economic value of a negative figure of some substantial proportions.

Seven years later, the company has an economic value of something that is positive, and now everybody is trying to buy it. It has a positive economic value even though statutorily it is rather insolvent, but it is protected under the court plan of rehabilitation. So that is why I think it is important to know whether or not the company does have a positive economic value in the face of statutory insolvency.

MR. BICKEL: As far as this particular situation is concerned, I have one in mind right now where there are no assets, just liabilities. I think the question should follow essentially the same process that we described earlier. The main difference is that the seller is the insurance department, and possibly the people that back up the guaranty fund. You won't have any trouble getting holding company approval, but the thing we are concerned about is the persistency problem. How are these policyholders going to react to a new company assuming the business.

MR. RUGLAND: Let's look at the second case. I'm sure some of these basic concepts will come back.

#### B. Situation For Discussion

Agony Life, Accident and Surety (ALAS) is a regional life insurance company ranking 143rd on the list of U.S. life insurers by inforce. It is a Los Angeles stock company doing ordinary only business in 15 states (the stock is concentrated in three families).

Since its organization 40 years ago it has concentrated marketing efforts in the unaffluent market. ALAS' President Bigosh has told the Board, "The time has come for us to be in the home service business. We need to find a home service company that complements our territory which we can use to make it happen!"

He had one in mind, Fidelity Insurance of the Southern Highlands (FISH). "I've talked to FISH's President Synker and he likes the idea overall," Bigosh said. (FISH is a publicly held company in Chicago. Founded in 1900 it is primarily operative in states between Philadelphia and the Mississippi River.)

The ALAS Board agrees to pursue the suggestion and authorizes retention of legal, accounting and actuarial counsel to assist in the activity. The ALAS chief actuary is appointed corporate officer in charge of the details surrounding the potential affiliation.

(The panelists' assignment is to describe the role they will play in the subsequent activities, focusing specifically on two or three items of their involvement that are critical to the consummation of ALAS-FISH get-together.

Steve, maybe you have some comments on this and from the viewpoint of the ALAS Chief Actuary.

MR. BICKEL: Since at least one of these companies is publicly held it is likely that the Board of Directors is going to want professional outside advice as to the terms of the exchange. This type of advice may be necessary to protect them from suits by stockholders and it will also be useful in obtaining the holding company approval. The companies may well look to their actuarial departments to develop the support for the determinations.

If a professional analyst is employed to express an opinion, the actuary should be prepared for a very thorough audit, much more than normal auditing by accounting firms. A good analyst, or a good firm of analysts will be more interested in current values of assets and liabilities than the historical values, and they may request substantial amounts of documentation regarding the profitability of the more significant plans. They will be more impressed with documents prepared before the merger than after the merger was announced, so you will likely find yourself explaining what was done in the past. If you wrote a memo to your boss a year ago saying that something was a loss leader, you may regret having to explain it to the professional analysts. An experience of this type will impress you with the importance of maintaining high professional standards in your in-house communications.

The first thing that needs to be decided here is, "Who is going to be the surviving boss of these companies?" This is not clear from the facts we are given, and that assignment can be given to the two Presidents to work out.

A second question is whether or not they want to have a legal merger. There are a number of possibilities to consider. For example, they could have two corporations and consolidate operations in one home office. They could also merge the two corporations into one but keep separate administration through regional home offices.

There may be tax advantages in keeping the corporations separate. Possibly the state of domicile will give some premium tax break to one of the companies. If both companies are in a Phase II Federal income tax situation for GAAP purposes, there's probably no disadvantage to combining them into one company. However, cash taxes can be something completely different and that needs to be investigated.

All other things equal, a single corporation should be less expensive to administer than two. Having a single corporation, though, would probably force you to adopt a single ratebook, which you might not want to do for both the ordinary and combination operations.

The choice between single and separate administrative operations depends on the relative size and efficiencies of two offices. It is likely the combination company is better prepared to administer the ordinary company's business than vice versa. If all other things are equal, you might put both home office buildings up for sale to see which one was bought first.

The chief advantages to separate operations would be the ability to provide better service to the policyholders and agents and continue the goodwill of the community.

MR. BOWLES: Let me ask Steve a quick question. You kept talking about a professional analyst. How do you define a professional analyst?

MR. BICKEL: The one I have in mind is an investment counseling firm which has an actuary on its staff.

MR. BOWLES: Well, I'm glad you said that. We've found in our experience that when a company is having an appraisal made, unless the investment banker does have an actuary on board, whether it is an in-house actuary for the investment banking firm or an actuary that is independent of the company, you are going to get less than that with which you will be happy. I don't believe accounting firms, without the input of actuaries can really do the job that the public has the right to expect in such a process.

MR. LARSON: I agree completely. In fact, it brings up something that we have not mentioned yet which I believe can be significant in many acquisitions. The timing of the matter I am about to mention will depend on the nature of the acquisition. It will also depend on whether the acquisition is friendly and on how much management already knows about the business involved.

This process is what we call the businessman's review. We have developed a program that is quite extensive. This program lists the types of things that one might want to investigate including historical facts as well as future facts. The acquiring company should learn as much about the business as is possible including information on how they market their products as well as on how they handle their financial affairs. The businessman's review approach involves using various skills in an acquisition review including accounting, actuarial, legal, and others as the case may warrant. In applying the approach, the key is to know what the purchaser needs to know and then to focus on that question. All other review may be of little or no value.

From an accounting point of view, we obtain information for this review by reading auditor's working papers, internal financial statements, minutes of meetings, and other data. An actuary may review the profitability of key plans and an attorney may review the legality of products and risks inherent in any outstanding or possible litigation. Many times these reviews lead to uncovering problems that eventually dismantle a proposed acquisition. Although the result may be disappointing to our clients, it is better to uncover problems before a purchase is consummated than to be involved in the subsequent problems associated with making a bad acquisition.

MR. PLAYER: I would just like to take a minute or two and run through one possible way of structuring this type of acquisition and touch on state law requirements and securities law requirements. I think we have kind of covered the waterfront this morning. I think Steve has very adequately touched on the business considerations.

Then you get into the technical considerations, just how you put it together. I think in this situation where you have three families owning the stock of ALAS, and you have a public company formed in 1900, you really need to zero in on why the acquisition. Are there tangential reasons that could bear upon the structure? For instance, the age of the shareholders in ALAS..... do they have tax problems in their estates? It's a closely held corporation, do they need valuation for estate tax purposes?



One way to structure this, which is somewhat novel, is for the FISH Corporation to issue its share in a reorganization for the shares of ALAS. ALAS then becomes a wholly owned subsidiary of FISH. ALAS principals could be the officers and majority of the Board of FISH. If FISH has the authorized shares in its portfolio, and further, if the corporate law of the state does not require it (and many states don't), then a shareholder's vote is not required either by ALAS or FISH shareholders.

The drawback, of course, is that if you don't have a shareholders meeting, and you don't have a registration, then the ALAS shareholders get restricted stock. They are going to have restrictions on the stock anyway, but restricted stock is different. It means it is not registered, and if it is not registered, it means they have to hold it for two years and then they can sell under Rule 144. The volume of trading and the amount of shares outstanding may be enough to comfortably sell. Sales must be made through brokers' transactions; that is, you've got to give it to a broker and he's got to wait for an offer to buy. If that's the case, then I think you can really cut down on the expense of an acquisition like this. You can, as Steve pointed out, preserve all the licenses, all of the qualifications, all of the goodwill of ALAS, and have it a wholly owned subsidiary of FISH.

The point to be made here is look at the securities law implications. You needn't, but in the discussions with the attorneys, they should. Then look at the applicable state law.

MR. LARSON: As Steve said, look out for the taxes. I have seen a couple situations where merging caused the policyholders surplus account to reverse and a major tax liability be triggered. I have also seen other surprises in the tax area.

MR. BOWLES: It seems to me this is the type of deal that was structured over drinks in a Chicago bar by two presidents who were bragging to each other about the powerful computer systems they had in-house and they finally decided that each one of them was lying, and so maybe they ought to merge. Since, Agony is owned by three families, the guy who was speaking for Agony could say, "okay, we'll go" and then he calls in his consultants. My conclusion is ALAS called in the consultants too late.

There are several troublesome questions: One, why a home service company? Second, why the wide geographic separation between the ordinary operation on the West Coast and a debit operation between Philadelphia and the Mississippi River? Thirdly, having faced those two, does this tactic really mesh with the long range strategy of the Agony Life? Knowing that it is controlled by three families, the chances are that Agony Life has no long range strategy, so those are the questions I would put to them before we get down to the details of the acquisition itself.

MR. ROBERT C. TOOKEY: I'd like to emphasize a couple of the major points the panel has come up with. Specifically in regards to asking the right questions. Why is this merger taking place? Why not save the money, unless there are some important underlying reasons?

One thing that wasn't brought up is that FISH is publicly held, and perhaps widely so, which means a few dissident stockholders who may have very sincere reasons for not wanting to see the deal go through.

MR. PLAYER: Let me just mention this. I think in the structure that I posed there is no shareholder meeting of FISH and that the appraisal right problem is thereby avoided. But you are correct, and that, I think, is very important to think about ... the shareholder meeting and the appraisal right of minority shareholders. Of course, in some tax situations you cannot implement a tax free exchange if you have too many dissident shareholders.

MR. TOOKEY: I've seen more deals shot down by dissident groups of shareholders, some with valid reasons, some just out of blackmail. And you end up in a court after a reversed triangular split and it goes right down the line ten years later, before the last dissident shareholder is taken out of the picture.

MR. WILLIAM K. NICOL: I'm not sure that you've really got the expertise in this day and age when we talk about legal, actuarial and accounting. I see a lot of deals, and more recently I want my personnel officer in because EEOC and ERISA are those kind of hidden liabilities which every attorney certainly feels when he is doing an acquisition. In the last two or three that I have looked at, I don't want the stock anymore. I would rather be buying the assets. It is mainly because of the people responsibilities in taking on a company that are not represented by ERISA and EEOC considerations.

MR. RUGLAND: (In answer to a question concerning the competency of individuals in acquisition cases) I think it is a good example of the specialization that is coming for instance, in the actuarial profession. There are, in fact, actuaries that spend most of their time in this very thing, just as there are lawyers and accountants who become very expertise. It's not uncommon in any profession to have it develop to that extent now.

MR. LARSON: I can only give you one guideline and that is to try and be reasonable. I think it is important, if you have a significant acquisition, to make sure that any outside advisor knows what he is talking about and not go to him just because of who he is. Make sure he has completed some acquisitions successfully. If he hasn't, you had better satisfy yourself that he has the credentials, experience, and resources to get through the acquisition successfully and efficiently.

MR. BOWLES: Bill Nicol, I would hope you wouldn't need to have a personnel officer in to look at the liabilities under ERISA. I would hope that the actuary would have enough gumption and background in this to be sure that's a part of his overview. It certainly ought to be I think.

MR. PAUL T. BOURDEAU: I wonder what the panel might have to say about the monitoring or scorecarding of acquisitions that have been completed. I think it has been said that you can do them with relative impunity especially if the deal is complicated, and you merge half the operation and no one can really say whether it was a success or not, especially if the environment is changed, or stock prices have fallen in general. Steve, with a series or string of acquisitions, what attempts are made to monitor or report on completed deals?

MR. BICKEL: The ones that have turned out the worst for us are the mutual fund operations that we bought right before the industry went sour. There is no question that we lost a lot of money on those. I feel that we have done well at my company with life company acquisitions. If you keep the corporation separate as we have usually done, you will see the result right away as you consolidate the earnings in the next few years. In the few cases where a physical merger has occurred, the only thing we have done is an occasional check of the persistency of the business acquired.

MR. WALTER W. STEFFEN: In this case it isn't clear to me whether FISH and ALIAS are extremely friendly, or whether they are antagonists on the opposite sides of the fence as far as the acquisition is concerned. Obviously, the President of each company wants to secure the best possible position for his individual shareholders. I've heard the panel talking about securing expert advice and bringing in experts from the outside. What experts are you considering be brought in from the outside? Should each side be represented by their own experts?

MR. BOWLES: If I am a President of a company that is being acquired, I want my representation. If I am the President of the company that's doing the buying, I want my representation, so I don't think there's any question about it. The consultant really is not in the position to represent both parties. He shouldn't, because there's a conflict of interest. I think a person that moves into a deal like this and doesn't have adequate counsel from the outside, or wherever, is not prepared for what is to take place.

MR. LARSON: In many cases it is not necessary to have outside talent. There is often a pool of capable talent inside businesses and little or no help from outsiders may be necessary. The key is to identify the best people to have on your acquisition team regardless of their location or employment.

