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# ON THE MUTUALIZATION OF A STOCK LIFE INSURANCE COMPANY

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ABSTRACT

The author, having been involved in the mutualization of a stock life insurance company during the past decade, has been struck many times by the dearth of information on this topic in actuarial literature. This paper has been written in the hope that it will partially fill this void.

The paper will discuss the reasons for a company's mutualization; detail the mutualization process itself; consider actuarial, legal, and other problems that arise; and review a recent case history.

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## INTRODUCTION

Over the years, mutual life insurance companies have been formed in a number of ways. One of the earliest methods used, and one which today is of interest chiefly for historical reasons, involved the *purchase of insurance by each founder of the company.* Through such purchases sufficient money was collected to obtain a charter and start operations. As financial requirements for new companies became more stringent, this approach fell into disuse. Today only a large, coherent membership organization would have the requisite financial resources and leadership necessary to carry out such a complex undertaking. A second method employed in the past called for the *organization of a company with a "guarantee" capital.* Here the distinguishing feature is the "preconceived" plan for the stocks' retirement out of future earnings. Prior to the retirement of the capital, the stockholders typically are entitled to limited dividends and either exercise full control of the company or share such power with the policyholders. Today few entrepreneurs would be interested in a financial undertaking where not only would the return on their capital be limited but also their interests could be bought out when the venture proved successful. A number of companies *organized originally as assessment societies* were converted subsequently into mutual companies on a legal reserve basis of operation. Some mutual life insurance companies were *organized originally as fraternal societies* and subsequently mutualized. Because of important tax advantages enjoyed by fraternal societies, such conversions are infrequent. Most of today's mutual life insurance companies were formed through the *mutualization of a stock*

*company*. Mutualization is the process by which the stock of a life insurance company is purchased by the company (i.e., retired) and the ownership and control of the corporation are passed on to the policyholders of the company.

Although five different approaches to the formation of a mutual life insurance company have been described, the only process which has had practical significance in the past few decades has been that of mutualization—the subject of this paper.

## THE CONCEPT OF MUTUALITY

Mutuality is a concept prevalent and important in relatively few industries. Insurance and savings organizations come most readily to mind. The concept takes hold where large sums of money are managed for the benefit of individuals—that is, a strong fiduciary responsibility is present. Although the policyholders nominally are in charge of a life insurance company, actual control is exercised by the company's officers and board. It is the insurance department's task to ensure that this control is exercised for the benefit of the policyholders.

## WHY DOES A STOCK LIFE INSURANCE COMPANY MUTUALIZE?

The following are some of the considerations that might lead a stock life insurance company to mutualize.

1. *Adverse public opinion*. It is difficult to conceive of a commercial organization with a fiduciary responsibility greater than that of a life insurance company. Violations of this trust might include excessive expenditures, personal loans to stockholders, investment manipulations, and the like. These questions in particular were raised at the time of the Armstrong investigation.
2. *Estate tax problems of stockholders*. The problem here is an excessive valuation or a forced sale. This problem is exacerbated when a few individuals have large holdings of a stock infrequently traded. The current depressed level of life insurance stocks and tax code changes permitting a longer payout of estate taxes have de-emphasized this as a major reason for considering mutualization.
3. *Operational difficulties*. This would include financial problems, decline in competitive position, conflicts among the stockholders themselves, and so on.
4. *The wish to prevent the control of a company passing into foreign hands*. This was the major raison d'être behind the mutualization of the large Canadian companies.
5. *The wish to prevent control of a company passing on to unfriendly hands*. Depending on one's point of view, these companies were threatened by adverse speculative interests or the officers were seeking to save their necks.
6. *Depressed stock prices*. This is one way of having one's stock purchased at a "fairer" price.

### THE MUTUALIZATION PROCESS

Insurance codes vary in how they present the mutualization process and its requirements. However, the statutes generally contain provisions stipulating the following:

1. A domestic stock company may become a mutual company if all interested parties (board of directors, stockholders, policyholders, commissioner of insurance) agree.
2. The company will hold such stock in trust until all the outstanding stock has been acquired. Some statutes specify under what conditions the mutualizing company can force the sale of minority holdings.

Basic to the mutualization process is the drawing up of a plan of mutualization, which plan generally must be approved by the commissioner of insurance. Such a plan typically makes several stipulations:

1. The purchase price to be paid to the surrendering stockholders. The purchase price may be determined by the parties themselves as part of the mutualization process or by court-appointed appraisers.
2. Payout schedule of purchase price.
3. Amount of interest to be paid on unpaid balance.
4. Source of principal and interest payments.
5. Level below which surplus cannot be reduced.
6. Changes in operations contemplated—for example, discontinuance of sale of nonparticipating insurance.
7. Provision for the separation of accounts between nonparticipating and participating.
8. How moneys will be set aside for shares not tendered.
9. Naming of trustees and procedures for their future replacement.
10. Procedure for meeting of policyholders and stockholders to conclude mutualization.

### LITIGATION HISTORICALLY INITIATED BY PARTIES TO THE MUTUALIZATION PROCESS

Two forms of litigation may be initiated by companies. The first is action directed against dissenting minority stockholders to force surrender of shares, as authorized by the relevant state mutualization laws. The purpose here is to conclude a mutualization process when the overwhelming majority of the stockholders wish to do so. The second is petition to court to approve the appraised value of the company's capital stock still outstanding and order the surrender of such shares.

Litigation also may be initiated by stockholders, to prevent the company temporarily or permanently from changing its structure to that of a mutual organization. Generally the purpose is to secure directly or indirectly a greater valuation of the stock.

Finally, litigation may be brought by policyholders. Sometimes attorneys attempt on behalf of policyholders to hold up or prevent a mutualization process. The stated object is to prevent an unnecessary outflow of company surplus—surplus which is there to protect the policyholder.

### ACTUARIAL CONSIDERATIONS IN THE MUTUALIZATION PROCESS

A company can be valued as the sum of (1) statutory capital and surplus; (2) nonadmitted items which have real "value"—typically, advances to agents, furniture, and equipment; (3) assets which are undervalued—office buildings, corporate subsidiaries, and the like; (4) liabilities which are in reality an allocation of surplus (the security valuation reserve is one obvious example; others might include mortality, morbidity, or interest fluctuation reserves); (5) present value of earnings on in-force business; and (6) present value of earnings on future business (in lieu thereof a value can be put on the home office and field operations).

Special problem areas include the following.

1. The rate at which earnings are to be discounted. Justifiable rates might range from 6 to 18 per cent. The subsequent variation in value is enormous. Earnings on future business are generally discounted at a higher rate than in-force business.
2. Limitations on stockholders' earnings from participating business.
3. Projection of profit on future business.
4. Choice of market or book in valuation of bonds and mortgages. If book value is used, annual statement interest can be used as a base to project earnings. If market value is used, "market" interest rate should be correspondingly used.
5. The extent to which information secured in the calculation of GAAP earnings and/or surplus can be employed.

### OTHER FACTORS IN DETERMINING MUTUALIZATION PRICE

Other considerations that affect the price of mutualization may be summarized as follows:

1. The mutualization should be of benefit to policyholders, if not immediately, then certainly in the long run. The mutualization should not constitute a danger to policyholders by threatening insolvency. Thus a long-term forecast of emerging surplus is imperative. Canadian law, as an example, dictates that surplus cannot fall below 6 per cent of assets.
2. The purchase process should be completed within a determinable period—say, ten years. That is, the company must be able to make principal payments including interest without impairing surplus.
3. The final price should be a fair one for all concerned. It should take into

account the stock's market value and the company's dissolution and going-concern value.

4. The final price is generally set somewhat above market value to induce a sufficient number of stockholders to go along and to reduce the possibility of a counter offer.
5. Current and prospective earnings are a factor. If earnings are low compared with dissolution value, the price offered generally will be reduced—that is, the company is worth more dead than alive. This may indicate that the company is not efficiently managed.
6. The offer should take into account the tax situation of stockholders.
7. A low dividend rate to stockholders will induce the submission of shares. Thus, as Canadian stocks rose in value, large stockholders found it difficult to sell their holdings, since potential investors did not like the low yield and concomitant tax problems.

### HISTORY OF A RECENT MUTUALIZATION: FARMERS AND TRADERS, 1974

Farmers and Traders was incorporated in 1912 with an authorized capital stock of 2,000 shares, later increased to 3,000 shares. Through December 31, 1954, the company sold primarily nonparticipating individual life insurance policies.

In 1953 a group of investors sought to buy up the controlling stock of Farmers and Traders. Their offer was $900 a share. To counter this offer, the company organized a voting trust and adopted a plan of mutualization in accordance with section 199 of the New York Insurance Law. Under the proposed plan, the company agreed to pay $1,000 per share, amortized over a period of ten years with 3 per cent interest on the unpaid balance.

Commencing with the plan's effective date, all business written was to be participating. The mutualization plan went into effect on January 4, 1955. By the end of 1955 a total of 2,756 shares had been tendered. In addition, thirteen shares were held by directors. Over the next decade an additional thirty-eight shares were tendered. This still fell short of the 95 per cent control required to force a mutualization.

This attempt at mutualization precipitated a protracted series of legal maneuverings.

#### Young *v.* Farmers and Traders (*1954*)

Plaintiffs (dissident stockholders) argued that the directors and officers were promulgating a plan of mutualization in order to perpetuate themselves in control of the company; this was claimed to be a fraudulent purpose. The courts declared that the power to organize a voting trust

was not subject to attack for fraud or any other reason. The right was an arbitrary one that stockholders possessed.

Sylvander *v.* Taber (*1959*)

This case pertained to the constitutionality of section 199 of the New York law. Plaintiffs argued that company surplus which belonged to existing stockholders was being utilized to purchase outstanding stock for the benefit of current and future policyholders. The courts found the mutualization law to be valid. It was further held that stockholders were not being deprived of their property without due process since the very laws that gave a stock life insurance company its existence also provided for its mutualization. In addition, the court stated that no stockholder was being compelled to sell his stock; since there was no compulsory taking, there could be no confiscation.

Sylvander *v.* Farmers and Traders (*1960, 1965*)

This action sought the payment of increased stockholders' dividends. Plaintiffs concomitantly charged that the company was charging the nonparticipating branch improperly with expenses incurred in carrying on the participating business. In addition, plaintiffs commenced an action against the officers and directors for losses sustained in writing participating business. These actions continued until the appraisal proceedings were concluded in 1974.

The petitioners also commenced an action in 1964 to declare the plan of mutualization as frustrated—impossible of performance because the remaining stockholders would not sell their stock. The courts disagreed, ruling that there was no provision in section 199 of the New York law that precluded the company's proceeding with its plan of mutualization indefinitely.

*Insurance Law Amended* (*1966*)

The statutory procedure for stock surrender in effect during this period was voluntary, and there was no way for a company to compel a dissenting stockholder to surrender his shares. In 1966, section 199 of the New York law was amended in such a way that if a company controlled more than 90 per cent of the stock, and ten years had elapsed, the remaining dissenting stockholders could be made to sell their stock to the company through an appraisal proceeding.

Pursuant thereto, the company on August 10, 1967, made an offer of $2,500 for each share. The holders of 4 shares accepted this offer. Thereupon the company commenced a proceeding for an appraisal of the re-

maining 189 shares. Concomitantly the parties entered into negotiation in an attempt to agree on a fair value of said shares.

On May 21, 1970, the company and the dissident stockholders agreed in principle to settle and discontinue all litigation. Under this tentative agreement and subject to the approval of the superintendent of insurance, the company would pay the outstanding stockholders $10,000 per share, payable 20 per cent down with the balance in four equal annual installments with interest at 6 per cent.

On review, however, the superintendent took the position that the agreement was a "new offer" and that therefore an independent appraisal should be made of the stock at the expense of the company. The dissident stockholders moved in Supreme Court for an order declaring that the agreement was not a new offer and that the superintendent should be required to approve the agreement without requiring an appraisal. The Supreme Court agreed that the $10,000 per share was not a new offer, but directed the dissident stockholders to apply immediately to the Court for the appointment of three appraisers in accordance with the statute. The Court in effect decided that, once statutory proceedings had begun, the parties could not fix the purchase price by agreement and thereby bypass the procedure prescribed by the new law.

On appeal this opinion was sustained. In any case, the price to be fixed by the appraisers had to be confirmed subsequently by the Court and the superintendent of insurance.

The appraisal proceedings finally commenced on May 22, 1972, when three appraisers were appointed.

The appraisers were mandated by statute (New York Insurance Law, sec. 199[4][c]) to "estimate and certify in writing the fair value" of the outstanding shares as the date of the making of the offer by the company (August 10, 1967). As to the definition of "fair value," the statute was and is silent. The appraisers in their final report analogized the insurance statute to a somewhat similar statute granting the "right of appraisal" to fix the value of shares when a shareholder dissents from certain fundamental corporate changes or actions.

The appraisers considered three approaches in determining the value of Farmers and Traders: (1) market value, which in this case was essentially nonexistent; (2) net asset value, an adding up of the shareholder's interest in the company's assets; and (3) investment value, using a price/earnings ratio as applied to shareholder earnings.

The appraisers emphasized repeatedly that valuing the petitioners' 189 shares presented a "factual situation," unlike that in the usual proceedings to determine the value of shares of a given concern. This came about

because, as of the valuation date, the company had a closed block of nonparticipating policies and was actively issuing only participating business. They also made the point that the proceeding was a statutory one and that it had no resemblance to an action to dismantle a corporation.

The appraisers determined that, among other things, the following belonged to the stockholders:

1. The present value of future profits on the nonparticipating block of policies.
2. The "statutory recognized possible right of stockholders to a stated portion of profits on participating business." In the past this had never been implemented affirmatively by the company's board of directors.

In this regard it should be noted that New York does mandate the separation of earnings in both blocks of business through Schedule NP of the Annual Statement.

The dissenting stockholders' actuarial expert (the author of this paper) expressed the opinion that the per-share value of the stock as of August 10, 1967, was $15,000, composed of the following elements:

| | | |
|---|---|---|
| Capital and adjusted surplus | $ 9,124,000 | |
| Value of in-force business (nonparticipating, participating, health) | 15,008,000 | |
| Value of home office and agencies | 2,000,000 | |
| Subtotal | $26,132,000 | |
| Additional value of Farmers and Traders stock purchased at $1,000 per share but carried on books at $100 per share— its par value | 2,529,900 | |
| Expenses charged from 1955 through 1967 to nonparticipating earnings which should have been charged to participating business | 1,234,000 | |
| Total | $29,895,900 | |
| Divided by 3,000 produces | | $ 9,965 |
| Special surplus set aside for dissident stockholders | | 2,500 |
| Added intrinsic value | | 2,535 |
| Per-share value | | $15,000 |

The company's (respondent) actuarial expert expressed the opinion that the per-share value on the same date was between $2,300 and $3,005. In addition an appraisal made by a third consulting actuary in June, 1967, at the request of the company was on the record. This appraisal suggested a per-share value of $5,206 as of December 31, 1966. In their

deliberations the appraisers arrived at a value of $7,100 determined as follows under the asset value approach:

| | |
|---|---|
| Capital and adjusted surplus | $ 9,590,124 |
| Value of in-force business (nonparticipating, participating, health) | 11,000,000 |
| Home office and agencies | 1,000,000 |
| Total | $21,590,124 |
| Divided by 3,000 produces | $ 7,200 |

The "times earnings" approach gave an essentially similar value, and the appraisers ultimately settled on $7,100 per share.

The appraisers in making their determinations concluded the following:

1. The fact that the company agreed originally to pay the petitioner $10,000 was not germain to the appraisal proceedings. As the appraisers put it, "It is a recognized legal principle that a party may with impunity attempt to buy his peace, but if the attempt fails, proof thereof is not admissible."
2. The appraisal had to be made on the facts existing as of August 10, 1967, and not on subsequent facts or happenings.
3. Whatever value the redeemed shares had, it belonged to the policyholders and not to the stockholders. The petitioners had theorized that, since the company generally had paid about $1,000 for each of the 2,811 shares acquired, and was only holding $281,100 as an asset, an additional $2,529,900 (2,811 × 900) belonged to the shareholders.
4. The company's division of expenses in Schedule NP between participating and nonparticipating should stand.
5. The special surplus liability of $466,800 (or $2,500 per outstanding share) which had been established by the company as part of the mutualization process in order to buy out the 189 shares still outstanding belonged to the company, to be used at least in part to pay the amount ultimately determined. It did not belong to the dissident shareholders as the petitioner opined.
6. There was no reason to assign any additional value to these 189 shares because they constituted the only outstanding shares—that is, an intrinsic value because of their nuisance value and because of the possibility that the insurance law might be declared unconstitutional.

The appraisers held that they could give no opinion as to whether interest should be allowed, since section 199 of the New York Insurance Law made no provision for the payment of such interest. The question was argued before the Court. It was agreed ultimately that interest at the rate of 5.13 per cent, the company's average return during this period, less the amount of any dividends declared, should be paid. The superin-

tendent of insurance concurred. The paying of interest from August 10, 1967, to August 29, 1974, increased the amount paid out per share to $9,248.57.

## CONCLUSION

The mutualization of a life insurance company is a complex undertaking requiring the talents of many diverse disciplines. Invariably, actuaries are key characters in the play that ensues. All too often it is a process that takes decades to bring to fruition. In order to streamline the process and concomitantly reduce cost, the following recommendations are made:

1. If, say, over 90 per cent of the shares have been secured, a stock company should be able to force the sale of the minority holdings.
2. There is an urgent need to reduce the protracted legal sparring and costly court battles that often ensue in the mutualization process. The fact that fees of appraisers, lawyers, actuaries, and other consultants are to a large extent paid by the insurance company has a tendency to relax economic considerations.
3. If a company and minority stockholders agree on a purchase price, it is questionable whether appraisal proceedings should be required.
4. In lieu of appraisal proceedings there might better be an independent actuarial appraisal of the outstanding stock. This may require one or more independent consultants, depending on the circumstances. Legal proceedings in which each side produces its own expert witnesses often generate more heat than light. Counsel for both sides often push the experts to the limits of what they, the experts, can live with. Thus, with each side overselling its case, the appraisers often end up in the dark and willy-nilly try to steer a middle course.

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