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MERGERS AND ACQUISITIONS OF LIFE INSURANCE COMPANIES

Moderator: SAMUEL H. TURNER. Panelists: JAMES F. BETTS, DAVID B. DILLARD**, THOMAS A. PLAYER***, ROBERT D. SHAPIRO*

The session will represent an inter-disciplinary approach to the general topic with emphasis upon the following selected issues:

1. Management perspective, what is the takeover wave doing to the industry and how is it affecting individual company operations?

2. Key legal aspects in takeovers, especially Board and management responsibilities and liabilities.

3. Practical alternatives in performing actuarial appraisal valuations, including what to do about limitations of time and information.

4. Structuring and evaluating the financial consideration offered in a takeover.

MR. ROBERT D. SHAPIRO: My remarks will cover practical aspects of appraising a life insurance company. Aside from a brief description of what constitutes an actuarial appraisal, this discussion will not go into the details of projecting and discounting a life insurance company's earnings.

What is an Actuarial Appraisal?

Essentially, an actuarial appraisal process involves characterizing the expected future operating environment, projecting the future earnings of the company based on this characterization, and bringing these projected future earnings to a present value at an appropriate discount rate. The key issues that must be addressed in this process are:

...What is the future operating environment? Consider both internal variables such as administrative and marketing capacity and external variables such as competition and the economy. Also reflect how management plans can modify the environment that would be created by merely extrapolating past history.

...What earnings should be projected? Statutory, GAAP, cash flow, or ??? Although traditionally appraisal calculations have been based on statutory values, the results using GAAP values should be the same if appropriate evaluation techniques are employed. Value is value--the intrinsic worth of an organization should not change because a different accounting basis is used!

*Mr. Betts, not a member of the Society, is President & Chief Executive Officer, Life Insurance Company of Virginia, Richmond, Virginia.
**Mr. Dillard, not a member of the Society, is Partner, Lazard Freres & Company, New York, New York.
***Mr. Player, not a member of the Society, is Managing Partner, Neely, Player, Hamilton & Hines, Atlanta, Georgia.

...What discount rates should be applied? The discount rate should reflect the degree of uncertainty related to each specific projected earnings stream. It also will be related to the way in which federal income taxes are handled in the underlying projections. Ideally, after-tax statutory earnings will be projected and discounted to a present value using an appropriate after-tax discount rate.

How Are Actuarial Appraisals Approached?

The typical components of the "classical" actuarial appraisal are:

...the capital and surplus--adjusted for certain items, such as the MSVR and deficiency reserves,
...the value of the insurance in force on the appraisal date, and
...the value of the insurance to be written after the appraisal date.

Models generally are developed for major subsegments of each component, appropriate actuarial assumptions developed from the predefined future environment, and earnings projected and discounted to a present value.

Some of the major actuarial assumptions that need to be developed are as folows:

...mortality
...interest rates
...lapse rates
...expenses
...federal income tax
...future business (mix and amount)
...discount rate

An insurance company very quickly becomes what it writes. Typically, after five years the value of the business on the insurance company's books might be 50% of that written in the previous five years. After ten years, the value of the business on the books might be 75%-80% of what was written in the previous ten years; so, while it is difficult, future business is a very important component and has to be evaluated in an appraisal.

An unrestricted, full-blown classical appraisal involves a significant amount of time, manpower, and computer power. The rule-of-thumb approaches utilizing values such as "$X per $1,000 in-force" represent the other end of the appraisal complexity spectrum. In between these two extremes lie various actuarial appraisal approaches which involve varying degrees of sophistication, data, and outside involvement. For example, when life company targets are being identified and evaluated, there often is only public information available (e.g., annual statement blanks and 10-K's); and aggregate earnings projections and values are derived from this limited data base.

Why Are Actuarial Appraisals Developed?

Actuarial appraisals provide valuable information about the financial operations of a life insurance company. Often life insurance company management will develop the projections and appraisal values as an integral part of their long-range planning process. Such information is essential for any

company that wants to dress itself up for sale or defend itself against possible tender offers. It also is critical input to a potential buyer seeking to establish an appropriate price for a tender offer.

Other situations in which appraisals often are developed include (a) valuing a company in financial difficulty for a regulatory agency or majority stockholder, (b) valuing a minority shareholder interest for possible buy-out, and (c) establishing a proper exchange ratio for two companies that have tentatively agreed to merge via an exchange of stock.

In summary, actuaries may be asked to perform appraisals for company management, company ownership, majority shareholders, minority shareholders, prospective purchasers, securities firms, investment bankers, state insurance departments, or other supervisory authorities.

What are Some of the Typical Problems Encountered in an Actuarial Appraisal?

Many actuarial appraisals are developed because a specific situation occurs that requires the company to obtain an appraisal. Such situations usually involve very tight time frames and may require abbreviated actuarial techniques even where there are no limits on data and people availability. An illustration of this type of situation is when a company seeks to defend against an unfriendly tender offer.

Often, the situation requiring an actuarial appraisal involves a high degree of sensitivity and confidentiality. The potential for litigation in these cases is high, and the actuary must develop his appraisal on a cautious, well-documented basis. Conflicts of interest may exist (e.g., where Company A asks a consultant to appraise the consultant's client B). These conflicts must be carefully resolved. Even the appearance of conflict can be damaging to a professional actuary; often the only satisfying resolution of a conflict is declination of the assignment.

When an appraisal is done on either a public-data basis or limited time/ limited company access basis, the data base underlying the actuarial appraisal often involves a number of significant questions. The resulting appraisal values can vary substantially depending on what the answers to these questions are. Obviously, these uncertainties must be clearly communicated by the appraising actuary to his client.

Another problem that arises occasionally occurs when an appraisal provides unexpected results. Pressure to modify or suppress an appraisal report may be encountered, and the actuary obviously must react with a high degree of professional strength in these situations!

Sometimes, a client will want to use an appraisal for purposes other than that for which it was intended. Unless the purpose of the appraisal is clearly stated in the actuary's report, this can be difficult to deal with. Actually, the last two problems emerge primarily because of inadequate project definition, poor communication, or simply a poor choice of client.

How Can These Problems Be Avoided?

Probably the most important step in avoiding the types of problems outlined in the previous section is to define the purpose, methodology, and audience for the appraisal very carefully. When this information is understood clearly

by both the appraiser and his client, the likelihood of misunderstandings and conflicts is small. An important part of this project definition process is becoming familiar with the client, the person who will be using the appraisal results. Occasionally, the actuary will get bad "vibrations" about the trustworthiness of the client; and, in these cases, the actuary should consider seriously declining the assignment.

Once the assignment is defined in writing to the satisfaction of all parties, there are other protective actions that can be taken. For example, consulting actuaries occasionally will obtain indemnification agreements from their clients designed to limit their risk and potential cost of defending lawsuits. Legal counsel often will be retained to provide a sounding board throughout a major appraisal project.

In the last analysis, the actuary's best protection will be in developing the appraisal on a professional, quality basis. The critical elements of a "professional, quality" approach include:

...using quality professional actuaries,

...applying sophisticated actuarial tools,

...carefully documenting the appraisal work and the limitations relating to interpreting the appraisal results, and

...calling on other professionals to "peer review" the final appraisal report before it is released.

If an actuary develops his appraisal using these four basic guidelines, he will go a long way toward eliminating the problems that otherwise might occur in an actuarial appraisal assignment.

MR. JAMES F. BETTS: It is somewhat intimidating to serve on this panel this morning, because three of the other four participants served as consultants in the merger of Richmond Corporation or Life of Virginia with the Continental Group. I always have wondered if they were at all curious as to what might have happened after they packed their tents and went home. There are those of us who remained behind to try to carry on the business.

I prefer to talk about things that I know about. For that reason, I will not try to hypothesize about the effects of mergers involving life insurance companies on the industry or the future trends. I will leave the techniques and values and investment ramifications to the attorneys, the actuarial consultants, and the investment bankers. Instead, I will try to give a straightforward view of the effect on one life insurance company (Life of Virginia) of its merger into one industrial company (the Continental Group).

I expect that there are distinct differences for a life insurance company that is merged with an industrial company rather than another life insurance company. None of what I will say about being merged will apply to a merger with another life insurance company because I have had no experience with that kind of situation and could only speculate on its consequences.

However, being merged with an industrial company--at least one particular industrial company, the Continental Group--is something that I have experienced and found to be, on balance, helpful to our company. It has been

helpful in at least three different ways which can be described broadly as stimulating, demanding, and rewarding.

Generally, under the heading of stimulating would be the inclination of an industrial company not to understand all there is to know about a life insurance company. In our case, because the Continental Group realizes that their depth of understanding of the life insurance business is limited, they have a tendency to ask a lot of questions. Moreover, the kind of questions they ask are from a different viewpoint than would be customary for insurance people. The questions vary from routine and normal to good and, occasionally, completely off the wall. When you attend meetings and know you will be asked a lot of questions but have no idea of the type or direction of those questions, it tends to be very stimulating. Moreover, they have not yet learned to understand answers which are given in a language which might be described as insurance code and, instead, prefer to have answers given in English which they can understand. While this makes the answers a little longer, it also requires a greater amount of clear thinking and understanding for those giving the answers. In my opinion, this is helpful and constructive for both the questioner and for the answerer, not to mention the chief executive officer who occasionally finds himself in the role of moderator. Carrying this a little further, the relationship sometimes is all the more stimulating because these industrialists, who are new to our business, do not know and certainly do not accept all the traditional reasons that people in a larger and older company like ours may give for not doing--or for doing--many things. In short, the Continental people have a tendency to ask "why?" fairly often.

Perhaps some of the reason for their outlook is that they live in a considerably broader world than an insurance company does. Continental is involved in the manufacture of cans, the paper business, the plastic business, most forms of packaging, and now, the natural resource business through the Florida Gas Company. Their businesses are worldwide. They are inclined to think, not entirely incorrectly, that the principles of various businesses ought to be similar. As they ask why we cannot do something as rapidly or as well or as effectively as it is done in one of their other businesses, a challenge and a new consideration is presented to our management.

It has been our experience that the Continental folks are extremely bright and can understand readily the differences that exist between our business and other businesses when they are explained intelligently and clearly. We have found that we have been entirely capable of defending ourselves from bad ideas, just as we have been able to benefit from good ones.

Secondly, I suggested to you that our relationship with an industrial company (at least the Continental Group) is demanding. Such a company is used to operating within much shorter time parameters than are customary in the life insurance business. Generally, life insurance companies tend to operate in a fairly relaxed manner, confident that things cannot change very much, very rapidly. An industrial company thinks differently. By way of example, they are used to having clearly developed information on operating results available quickly after a reporting period ends. In our particular case, the Continental Group expects to have operating results available by the sixth working day of the month. Most life insurance companies do not meet that schedule nor did we think we could until we tried it and, at least from the chief executive's point of view, found we liked it. The information they expect by the sixth working day is not just a bottom line after-tax profit figure. To meet the Continental requirements, we have worked with Tillinghast,

Nelson & Warren and have developed an extremely effective Management Information System which provides not only operating income information but investment, sales, marketing, and expense information in well over 100 categories. And this report is available not only to Continental but to our own senior management by the sixth working day. We manage more effectively and, at the same time, more comfortably, because of the demands of our industrial owner.

In another area, industrial companies, at least the Continental Group, place fairly heavy weight on long-range planning. Because the results of our business must be combined with and balanced with the other business, they want to have a pretty clear idea of where we think we are going, what is going on in our business, and our view of future prospects and paths. Occasionally, the long-range planning material they supply is a little cumbersome. For example, the price of tin in Libya has a modest impact on our business; but, in general, their demand that we be able to look ahead and think ahead has helped us.

Between short-term operating results and long-range planning lies the area of budgeting, and the requirements of an industrial company are apt to be considerably more stringent than is customary in most life insurance companies. Moreover, the Continental Group, at least, is inclined to place considerable emphasis on operating budgets and to ask that we compare performance and emerging results with budget rather than with last year's results. This practice, in itself, simple as it may seem, tends to tighten things up considerably.

Finally, I have suggested that we have found our relationship with the Continental Group to be rewarding. I do not necessarily mean this in the way of salaries. One of the reasons suggested to our management by those stockholders who favored the merger was the thought that industrial salaries customarily were higher than insurance salaries. Nothing has happened in our situation to change that. Industrial salaries still are higher than insurance salaries and we, in the Life of Virginia, continue to dream of the day we will achieve an industrial salary. In this case, I mean rewarding in the sense of the amount of interest our stockholders have in us and the level of enthusiasm they have for our good results.

Having invested about $400 million to acquire us, it is readily apparent that someone in New York had to stick out his neck a considerable distance. Someone or some small group who made the decision to invest that sum of money to acquire us had to place a considerable part of his reputation on the line. When this happens, that person (or group of people) becomes a new audience which is very eager to see us succeed. And, because of the size of the commitment, they do not just take our success for granted. In short, we get much more applause when we do well.

These generally are the environmental benefits that I think came to Life of Virginia from the merger. There are a couple of things that many people predicted would come to us which have not, and I think they are just as interesting.

First, many people told us that our dividend pay-up would be increased and that cash would be drawn out of Life of Virginia to benefit the Continental Group. That has not happened. In fact, our dividend pay-up to Richmond Corporation in the two and one-half years prior to July 1, 1977 was $34.9 million. Our dividend pay-up to the Continental Group in the thirty

months following the merger, July 1, 1977 to the end of this year, will be $35.7 million. The dividend pay-up has remained approximately the same despite the fact that GAAP operating earnings in 1979 will exceed those of 1976 by almost 50%.

Secondly, many people told us that we would be asked or told by Continental to invest in their activities, new plans, forest lands, or what have you. The plain fact is that Life of Virginia has yet to invest the first dollar in any activity owned or controlled by the Continental Group. Our investment operation has continued to run in an entirely autonomous manner; no Continental officer serves on our investment committee, none attends investment committee meetings, and the investment committee of our company still is dominated by our outside directors.

On the other side of the coin, people suggested that the Continental Group might be a source of substantial new business for Life of Virginia. This has not been the case; we underwrite none of their group insurance, next to no individual insurance, but we do invest a modest amount of their pension funds. The largest area of joint usage has been that we get to lease their corporate aircraft every now and then.

Now, let us turn to some of the difficulties we have experienced in being taken over by a large industrial company. I think you should expect less emphasis on the difficulties because, while I will be talking to you for ten or fifteen minutes, I will be living with the Continental Group on a somewhat longer term basis; and, while I may not be bright, I at least am prudent. Certainly, it is fair to say that during the period of time when the merger negotiations proceeded and for the first year following the merger, there was a high level of anxiety among our officers and our organization. A change of any kind tends to make an organization jittery, but the uncertainty of not knowing for sure whether the change is coming and, when it comes, not knowing what form the change will take, created a difficult situation throughout our company. The protracted merger negotiations and the shuffling for position after the merger were a distraction to Life of Virginia and did affect our performance negatively for a period of approximately six months.

Beyond that, we have found that being part of a company which employs approximately twenty times as many people as we do has subjected us to considerably more paperwork and routine which honestly ought to be described as silly. As a smaller company, we were less in the spotlight in terms of complying with various kinds of regulations which we now must accommodate because of Continental's more prominent national position. From our point of view, this means that we find ourselves occasionally "going through the motions" to the disadvantage of not having adequate time to do some things we think would be more important for our company. We also have the notion, not shared by Continental, that they must be overstaffed, judging by the number of people from New York who appear like the mythical rabbit, Harvey, "here and there, now and then, to this one and that one, at times of his own choosing"--to ask questions which we feel betray a shallowness of knowledge about our business. *These remarks do apply to people at the staff level and not to* line management which we have found to be competent and quick and informed.

A third area of difficulty is created because the Continental folks are so bright and interested and, therefore, have so many ideas. Some of their ideas are not very good, in our opinion, but when the source of an idea is your owner, it tends to encourage early consideration. We live in the pretty

constant apprehension that one of these days a bad idea will be shoved down our throat; but, in all fairness, this has not yet occurred.

I have tried to give you a general overview of the reactions and feelings that I perceive in Life of Virginia as a result of our having become the ward of the Continental Group. Much of what I have said is a synthesis of the opinions expressed to me by our senior officers.

How should I summarize all this? Generally, I believe that Life of Virginia is a more alert company today with a higher level of aspiration and better operating results than before the merger. I believe our financial integrity as a fiduciary of policyholder funds is intact. I believe that our future is brighter than it would have been without the merger. In short, despite the disruption surrounding the merger and their requirement to fit in as a part of a larger entity, I would vote today for the merger, just as I did in the summer of 1977.

MR. DAVID B. DILLARD: I am going to talk about the structure and the evaluation of financial considerations offered in merger transactions. Part of this is from the standpoint of the buyer who is primarily the party involved in the structuring side of a transaction. Assuming the buyer is attempting a friendly transaction, he must first evaluate his objective and the objective of the seller in deciding what the structure of consideration to be offered will be. The buyer's alternatives basically are twofold. If he has money available in the form of excess cash or bank credit, he probably could afford to offer an all-cash transaction, assuming the resulting balance sheet of his company and the company he is trying to acquire will be acceptably strong. If the resulting balance sheet is not acceptable, he may wish to offer all or, more commonly, part of the consideration in equity securities, such as preferred stock, convertible preferred stock, or a package of preferreds or preferred with common. In some instances, and these have been rare, a buyer may wish to offer some form of notes or debentures to the other company, in lieu of cash.

The interest, or lack thereof, to the seller in achieving a tax-free security exchange is an important consideration for the buyer when arriving at his appropriate structure. To accomplish a tax-free exchange, the buyer must pay at least one-half the purchase price in the form of voting equity securities, preferred, convertible preferred, common, or combinations thereof. Hence, when structuring a tax-free deal less than one-half the purchase price can be in the form of cash or notes. The buyer normally will consider several internal financial variables important to him (as opposed to important to the seller) when considering the alternative means of financing and structuring a friendly deal. The buyer usually will be as concerned with the near-term effects upon his earnings-per-share increase (or dilution) as with any other financial variables. From the buyer's standpoint, the cheapest immediate form of consideration clearly is cash or notes. Under recent market environments, the second cheapest form of consideration has been preferred stock; and the most expensive, common stock. Hence, and with the nearer term effect on earnings per share in mind, essentially all recent merger transactions in the insurance industry as well as in other industries, have been paid at least partly, if not entirely, in cash with the balance in some form of preferred stock. And it is rare indeed in recent history that companies have issued common stock in merger transactions.

A second financial variable considered by a buyer is the cash payout question. Usually, the buyer will consider the extent to which he can cover the cash payout on the cash or securities that he is offering in a transaction from dividends which he can predict from the acquired company. I would say that this issue tends to get particular attention in the acquisition of insurance companies where there are regulatory limits on the extent to which companies can pay dividends. Financially, there is no reason why it should get particular consideration in insurance companies, since non-insurance companies have financial restrictions on their own capacity to pay dividends; but in insurance acquisitions, the buyer normally does look at this and gives particular attention to it because of the regulatory question.

From the buyer's standpoint, the third most important financial variable of course is the resulting balance sheet from the combination and the amount of financial security he has going forward. I would say that there are two situations in which a buyer usually will propose an all-cash transaction. The first of these is when the buyer is a foreign company. There are only a few foreign companies registered with the FTC, and a good many of those that are not probably do not wish to be. Within the past several years, I can recall no foreign buyers of insurance companies or other kinds of companies who either have distributed securities directly to the shareholders in the acquired company or have sold securities in the United States market to raise money to finance the acquisition.

Unfriendly buyers will not propose a transaction involving the direct use of their securities. First, an offer involving the exchange of securities requires the offered securities to be registered in lengthy filings with the SEC. Such filings would be subject to intense scrutiny and attack by the target company in an unfriendly transaction. Secondly, the value of offered securities, in any event, is subject to competitive evaluation by the seller and his advisers, who will seek to denigrate their inherent worth. The value of cash, on the other hand, is not conjectural.

Third, and in the case of insurance companies, regulatory approval of the transfer of control usually is required prior to closing. And this means that any offer for an insurance company will remain outstanding for a period of months, during which time the value of any security offer is going to change with market conditions and be vulnerable to competitive cash offers from other buyers.

A fourth reason why an unfriendly acquirer will tend to offer all-cash deals is that he seeks to have the ownership of the target company put into the hands of speculative holders as opposed to long-term holders of securities. These are the so-called arbiters juris who will tend to buy at greater expense the stock of the target company which has been offered an all-cash proposal than that of a company which has a proposal of part cash or all securities. Basically, unfriendly deals usually are in the form of cash.

Structural considerations are less important to the seller than to the buyer. The seller's primary objective in a transaction, assuming he favors it, is to obtain the best possible price. An important consideration may be to obtain a tax-free transaction for the selling stockholders, in which case he has to negotiate to get at least one-half the aggregate consideration provided in the form of voting equity securities. There is one structural alternative I have not mentioned which may be of interest to the seller, and that is the alternative of putting installment notes into an all-cash

transaction. Basically, an acquirer in an all-cash transaction may offer installment notes to all stockholders which will defer taxes until the proceeds are received when the notes are paid off. The disadvantage of installment notes is that, for tax reasons, they must be issued with restricted marketability. An example of an insurance company acquisition where installment notes were used is the case where NLT acquired Great Southern, which was essentially an all-cash transaction with an installment-note option offered up front to Great Southern stockholders.

The valuation of a specific merger proposal is primarily the responsibility of the seller and his advisers. The valuation has two important aspects: price and adequacy of price. The price is rather easy to determine in the case of a cash offer. However, where securities are involved, the fair market value of the securities package, whether bonds, preferred stock, or common stock, may be less easy to determine. Often, for example, markets will not exist for the preferred stock or bonds of the buying company. The fair market value of securities offered must be appraised in advance of the markets, and the precise terms of securities may be subject to negotiation in the course of the transaction between the buyer and seller.

The second important consideration in evaluating the transaction for the seller is the question of adequacy of price. For public companies, the adequacy must be evaluated from the standpoint of the fairness to the seller and the selling stockholders. Investment bankers often are called in to assess and advise the board of directors of the selling company regarding this question. Judgments as to fairness normally are predicated upon or take into consideration several things, such as, the historic earnings and market value comparisons, book value relation, projections of future earnings, general economic conditions, and similar considerations. In the case of insurance companies, actuarial valuations also will be taken into consideration. Recently, the prices paid for similar companies is something which investment bankers have been taking more and more into consideration. I would say that in the case of insurance companies, particularly life insurance companies, the apparent general escalation of recent merger prices, mostly in cash transactions, has tended to simplify the process of assessing fairness to the seller.

MR. THOMAS A. PLAYER: I'd like to start my remarks with reading part of an article from an October Wall Street Journal. The article is headed "Offer to Purchase--ERC Rebuffed Again by Board--Connecticut General's Plan Is Unanimously Rejected--Sets Up Unfriendly Try"; the dateline is Kansas City, Missouri.

> "ERC Corporation again rebuffs Connecticut General's offer to buy it for $80 a share....
>
> "ERC, an insurance holding company, said in a prepared statement that its board unanimously rejected Connecticut General's offer, with one member absent. ERC said its directors recommended the company shouldn't even negotiate with Connecticut General because it used 'pressure tactics' and imposed a 'unilateral and arbitrary time frame' in seeking the transaction.
>
> "Earlier this week Connecticut General wrote ERC that it was offering $80 per share but was willing to negotiate until Monday on all points, including price. Connecticut General also said

that if ERC rejected its offer it would file documents to begin an unfriendly takeover.

"In early October, when ERC first rejected Connecticut General's offer, Stanford Miller, ERC chairman, said the company hadn't any interest in pursuing acquisition proposals from inside or outside the insurance industry. ERC's latest statement (I might add possibly after talking to their lawyers) however, said the board had authorized its officers and legal and financial advisers to 'explore all alternatives to the company and its shareholders'."

Well, that is just a kind of snapshot idea of what is going on in the marketplace today. I'd like to talk with you briefly about defensive tactics that can be used to fend off an unwanted acquisition offer or tender offer, the kinds of responses that I think are adequate and satisfactory for a board of directors to give, and the kinds of difficulties directors may find themselves in for inappropriate responses.

First, the kind of action going on between Connecticut General and ERC basically distinguishes the cash merger from the tender offer. In a cash merger, the acquiring company goes to the target company's board of directors and offers to merge. The board of directors has to approve the merger and then send it to shareholders for approval. In a tender offer, the acquiring company need not go to the board of directors; in fact, the board of directors of the target company need not make a recommendation either for or against. The acquiring company simply makes an offer to the shareholders who can choose to sell or not.

In the cash offer, minority shareholders are frozen out. In the tender offer, there generally will be minority shareholders. All shareholders will not want to exchange their shares and, because of our mobile society today it will be difficult to locate some shareholders: usually between 2 and 5%.

What is a tender offer? I cannot tell you what a tender offer is; nobody knows. A tender offer is whatever the target company can persuade the court it is. In the recent Becton/Dickinson acquisition where Sun Corporation acquired shares from about 31 individuals, Sun thought that was private placement, not a tender offer. The court has ruled it to be a tender offer and, because the acquirers did not file with the SEC before acquiring the shares from the 31 shareholders, there was a violation of federal securities laws. This case is going up on appeal. I think it is a bad law, but if there is public pressure to sell, if public announcement is made that shares are being purchased, and if shares are acquired on the open market, that probably is a tender offer.

Now, what about defenses? I will just run through these very quickly.

The Insurance Holding Company System Acts probably are the most pervasive and least used defense mechanism. They definitely are pro-management. Jurisdictionally, the holding company act that applies is that of the state of domicile of the insurer or of the ultimate controlling party; i.e., the the holding company.

Let us take the case of ERC. I am not familiar with the corporate makeup of that corporation, but let us suppose the holding company is domiciled in Missouri and owns an insurance company in Mississippi and one in Georgia.

In this case, approval must be obtained in all three states. The acquisition statement is filed, and at that time most states allow discovery. That is, if you are sitting on the Board of Directors of the target company and a Form A is filed (where the acquiring party makes notification to the target company) you can perfect discovery just as in any other judicial proceeding. At the hearing, the rules of evidence are much like a judicial proceeding. The filing of the Form A is very technical, and one aspect that bothers me a great deal is the requirement of certified financial statements for five years. Where acquiring companies are controlled by one or two persons rather than public shareholders, a good argument can be made that the individuals are the ultimate controlling parties and, therefore, their financial statements must be filed and certified for five years. As a defensive mechanism, if you can convince the insurance department that this is the case, very few wealthy individuals want their financial statements mailed out to shareholders of the target company.

Companion laws to the Insurance Holding Company System Acts are the corporate takeover statutes of the various states. Presumably, the Insurance Holding Company System Acts affect insurance companies and the corporate takeover statute affects business corporations. Although the corporate takeover statutes usually exempt transactions which are covered by the Insurance Holding Company System Acts, there are cases where the corporate takeover statutes have greater jurisdiction than do the Insurance Holding Company System Acts. Therefore, you may have a situation where both apply. Let us suppose that ERC had those insurance companies we spoke of and let us further say that they had a regional office in South Carolina. South Carolina has a corporate takeover statute which says that if you have contact with the state by way of ownership of assets or employment of a number of employees, that statute applies. In that case, there would be no domiciled company in South Carolina, so the Insurance Holding Company Systems Act would not apply.

Finally, there are the Federal Securities Laws. The Williams Act requires a filing prior to making a tender offer, and, as I said, there is a problem as to what is a tender offer. A company acquiring shares through a tender offer must make a prior filing with SEC and furnish an offering statement to shareholders from whom they are offering to purchase shares. Again, there is a lot of material regarding authenticity which the target company can question.

I want to mention something about the state corporate takeover laws which I overlooked previously. There are a lot of conflicting laws in the state corporate takeover acts; so many in fact, that, in a recent decision, the take over law of the State of Idaho was ruled unconstitutional because it impeded interstate commerce and the Supreme Court said the Williams Act applies to cash takeovers. I think there is going to be a real push to concentrate the regulation of cash tender offers at the federal level, and I don't think the State Insurance Holding Company System Acts are immune from constitutional attack.

Anti-Trust Laws - do they apply to mergers and acquisitions of insurance companies? I think they do. The McCarran-Ferguson Act dictated to the states the regulation of insurance. Mergers and acquisitions of insurance companies are not the "business of insurance", so Federal Anti-Trust Laws apply. The National Underwriter recently described a Missouri case, Fisher, et al, vs. Jones where it was held that, in

Missouri, a group of private individuals had a private anti-trust action against another group of agents, I suppose for anti-competitive action. This was opposed by the insurance commissioner under the Holding Company System Acts, saying that this union will impede competition. However, I think we all know that state insurance commissioners really do not have the jurisdiction nor the wherewithal to look adequately at the anti-trust implications of two large companies being merged.

Those are the statutory defenses. There are other defenses that can be imposed, such as charter amendments, bylaw amendments, and taking out a loan which will accelerate upon a change of control of the company. A company can have long-term and very highly compensated executives who are fully vested. All of these are defenses against an unwanted takeover. However, these defenses may put a board of directors in a difficult position, particularly if most of them are inside directors, because of conflict of interest. The thought I want to leave with you is that I think it is unwise for any board of directors to vote "not to sell at any price". At some point, it makes sense for the company to be sold, notwithstanding the fact that there are big plans in the future.

I think a director of a target company can insulate himself against conflict of interest by having a committee of outside directors meet on any acquisition proposal, by having an investment banker investigate the adequacy of a proposed offer, and by having an outside counsel look at the proposed acquisition with respect to anti-trust and securities laws. Another defense for the director is "the reverse bear hug" where you say, "you want to buy us for $80 a share, we will sell at $120." Put the response on the acquirer. The presumption is that a board of directors will act in the best interests of a corporation; and in a shareholder derivative action, a board must show that they did have a good business reason for turning down a premium acquisition of the company. If you are advising board members, or if you are an inside director, I think you will have little problem with the acquisition offer if you follow these thoughts.

MR. RICHARD S. ROBERTSON: I would like to correct an impression which might have been left by Mr. Player's comments relating to state insurance company holding laws. It is true that these laws represent an additional hurdle which a potential acquirer must cross before completing acquisition of an insurance company. However, it is not an insurmountable hurdle, even in a hostile situation.

These laws serve an important and indispensable purpose. As we all know, insurance is a regulated business. The primary thrust of that regulation is to protect the interests of policyholders, considering the substantial and long-term nature of the fiduciary responsibilities assumed by the insurance company.

The regulator has a number of important responsibilities when the change in control of an insurance company is proposed. Among other things, he will need to be assured that the acquirer will manage the insurance company with due respect to the rights of the company's policyholders and beneficiaries. He will want to be sure that the financial condition of the acquirer and the terms of the acquisition are not such that the acquirer will be forced to inappropriately utilize the assets of the insurance company to meet its financial needs. These are concerns that a regulator must satisfy when a company initially is licensed to do business, and they are no less a concern when control of the company is changed.

These responsibilities are not taken lightly. Even in a friendly acquisition, hearings normally are held and evidence must be presented to demonstrate the presence of the factors prescribed by the law. There is a recent example where the New Jersey insurance commissioner refused to allow completion of an acquisition agreed to by both parties because the acquiring company had allowed a property-casualty affiliate to go into bankruptcy a few years earlier.

There has been criticism of laws requiring state approval of proposed takeovers of general businesses, some of it justified. State insurance holding company laws should not be considered in the same category. The need for regulation of insurance companies places an important responsibility on the state insurance commissioners and the insurance holding company laws are necessary to allow them to exercise that responsibility.

MR. PLAYER: I certainly agree that is not what the law is for. My comments were meant to point out the kinds of defense mechanisms available, and I was being the devil's advocate regarding state insurance company holding laws. I don't know of any way you can keep from being acquired unless you are dealing with a leading company or a company which has absolutely no management in the insurance area. However, you can slow down any proposed acquirer, perhaps to the point that he either loses interest, finds another target company, or his borrowing can't support a long wait. But I do think your comments are well taken.