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DEMUTUALIZATION

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- o Overview of pros and cons of demutualizing
- o Legal and regulatory perspective
- o Current demutualization developments
- o Actuarial considerations of "how much," "in what proportions," and "to whom"
- o Structuring the demutualization
- o Implications of a public offering

MR. A. DOUGLAS MURCH: Demutualization -- the process of converting a mutual company to stock form -- has become a subject of great interest to mutual life insurance companies during the past several years. Most of the larger and many of the smaller U.S. mutual life insurance companies have been studying demutualization to determine whether demutualization is indicated, and if so, how it might be accomplished, and what it might imply.

Demutualization involves fundamental actuarial issues. At the same time, fundamental legal and regulatory issues are also involved, as well as issues from the field of investment banking and the public securities market. Our panel consists of outstanding senior representatives from each of three professions: legal, actuarial, and investment banking.

A prime feature of the context within which demutualization is being considered is the change over the past decade in the relative growth of mutual and stock companies. In 1983, there were 132 U.S. mutual life insurance companies. That was 13 percent less than ten years earlier. Correspondingly, in 1983, there were 1,963 U.S. stock life companies. That was 18 percent more than there were ten years earlier. Over that same ten year period, the assets of mutual companies as a percentage of life insurance industry assets declined from 65 percent in 1973 to 54 percent in 1983. Life insurance amounts in force for mutual companies

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declined from 51 to 42 percent of the industry over the same period. New ordinary life premiums declined from 52 to 34 percent. Total life, annuity, and health insurance premium receipts for mutual companies declined from 51 to 38 percent. So throughout, less of the life insurance industry's business is being done by mutual companies; more is being done by stock life companies. In these statistics, stock life subsidiaries of mutual companies are counted as stock companies and not mutual companies.

For new individual insurance business, most universal life, excess interest or interest-sensitive life, and variable life, plans are written through stock life companies, including the stock life subsidiaries of mutual companies. With all of these developments, it's small wonder that mutual companies are seriously looking at the possibility of converting to the stock form of ownership.

The demutualization issue is aptly captured by three basic questions, which most mutual companies have found themselves asking these days:

1. Could we demutualize if we wanted to?
2. Would we want to demutualize if we could?
3. If we do demutualize, how would we do it?

It's inevitable, that different mutual companies are going to reach different conclusions on this second question. In arriving at those conclusions, most companies will be evaluating the same potential advantages and disadvantages of demutualization. What are these advantages?

1. There could be a fundamental organizational advantage for the upstream holding company. The evolution of the financial services business and, particularly, forms of regulation, which apply to various segments of that business, are of concern to mutual companies with their current organizational structure. If in the future, the most effective way to become an active player in all segments of the financial services business is through an upstream holding company structure, then a change like demutualization would open up more completely a business opportunity to mutual companies that otherwise might be limited or denied to them.

2. Stock ownership provides easier, more direct, and more substantial access to the public equity capital markets. This would be advantageous for a mutual company seeking to expand its capital base beyond that which it could achieve by straight debt offerings or by remaining a mutual company and possibly engaging in equity offerings of one or more of its subsidiaries. Additionally, demutualization would enhance the possibility of acquiring other companies through exchange of stock rather than by a cash offer or leveraged buyout.

3. Under the current federal income tax law, there would be a significant reduction in the company's federal income tax after

conversion to a stock form. The demutualized company would no longer be subject to the mutual company equity tax portion of the present code.

4. Some mutual companies perceive that healthy pressures and motivations for improved financial results throughout the organization would flow from being a publicly traded company, with a sharpening of management's attention on earnings per share and on the market value of the company's stock.

5. Incentives, such as stock options, are available to stock enterprises. These can help improve the financial performance of the company, and help attract and retain high caliber management and executive talent.

There are some disadvantages of demutualization that have to be considered also:

1. Many mutual companies believe that in this increasingly "consumerist society," the mutual form of organization has customer appeal. There are no stockholders to compensate, and all the dividends go to policyholders. There are many in the career agency forces, particularly of mutual companies, that believe this is a marketing advantage of mutuality which should not be sacrificed.

2. The demutualization of a large company in the current legal and regulatory environment presents considerable challenges, risks, and obstacles in many jurisdictions. Some mutual companies feel that more work needs to be done to enact laws, remove obstacles, and reduce the risks before it would be feasible for a large company operating on a national basis to demutualize.

3. Some feel that the market pressures for preferred short-term earnings per share and high market value that would flow from the stock being publicly traded after demutualization, might focus undue management attention upon the current period's reported financial results at the possible expense of longer term performance. Some feel that internally developed financial performance measures tailored to the individual company situation might be able to effect a more appropriate balance between the long-term financial objectives and the short-term financial objectives of the enterprise.

4. Converting a company to stock form in the long run would probably lead to increased exposure to takeover attempts, especially considering the asset-heavy nature of individual life insurance and annuity business. Recent takeover experience among large corporations in the U.S. suggests that whether such takeover activity would serve the best interests of the insurance buying public is debatable.

5. Demutualization is a major undertaking. It consumes a substantial portion of the time and attention of top management and executives

> throughout the mutual company and incurs, at a minimum, a substantial one-time expense. Thus, to undertake it, the mutual company must be convinced that demutualization is among the company's most urgent priorities.

Obviously, the differing circumstances and viewpoints of various mutual companies will produce different conclusions on the balance of these pros and cons. But clearly, demutualization will continue to be a subject of interest at least for the balance of the 1980s and maybe continue into the 1990s as well.

Mr. Ira Friedman is a lawyer by profession and is responsible for following developments in the demutualization area. Mr. Friedman was previously in the Metropolitan's Tax Department, specializing in corporate law and insurance regulation. He is a graduate of New York University School of Law, and has an article called "Mutualism - Looking Back," in the May issue of Best's Review. He also coauthored "A Look at Demutualization" which appeared in the January 1984 edition of Best's Review (Life and Health Edition). Ira will start by giving us a legal and regulatory perspective on demutualization.

MR. IRA FRIEDMAN: The actuarial literature is rich in its discussion of the core legal issue facing companies that want to demutualize, namely, fairness to policyholders. This literature covers a variety of matters affecting mutual insurance companies, particularly mutual life insurance companies, like surplus management, the merger of mutuals, and so forth. It may be lawyers who will have to try the next case that comes to court challenging a conversion, but the experts on the witness stand will be actuaries. There are two fundamental legal principles that apply to any demutualization.

The first principle is that the world is a stage, and sitting in the audience are some hungry lawyers who won't pass up the chance to sue an insurance company. Actuaries -- and the rest of us who work for mutual insurance companies -- frequently make decisions that raise the question of fairness to policyholders. Dividends and surplus accumulation, investment in new business, and asset segmentation are just some of the matters where fairness to policyholders should or might have to be considered. Decisions on these matters are generally made in the privacy of the office, the executive suite, and the boardroom. They may be subject to regulatory review, but they are normally treated with some degree of confidentiality. A demutualization is public. The media will write about it. Agents and employees will ask about it. And the companies, their directors, actuaries, lawyers, and so on had better know what they are doing when they decide who will get what out of a demutualization.

The second fundamental legal principle is that you have to pass the "smell" test. Most judges, like the rest of us, follow a simple three-step process in deciding a matter. They listen to the arguments, *they decide whose side they are on; and then they look around for* support for the decision. In their search, they will find precedent to support either side. There have been cases in which fairness to policyholders was at issue, but for the most part, those cases took

place in settings other than demutualizations; some judges expressed views favoring the policyholder; other views favored the company. With few exceptions, we are talking about cases decided years ago.

Cases arising out of demutualizations are few and far apart. There may have been a hundred or so life demutualizations and a roughly equivalent number of property and casualty conversions, but few have ended up in court. Those that did proved the old adage that bad cases make bad law (unfortunately, it may be good law, but just bad news).

Let me give an example. In 1906, the Wisconsin Supreme Court decided the case of Huber v. Martin. The Germantown Farmers Mutual Insurance Company converted to stock form in 1904. It did so in accordance with the statute. It did so with policyholder approval. Was that good enough? No! Insiders had benefited. The court seemed to feel the legislators were coconspirators. The opportunity given to policyholders to benefit was so limited that the court felt it was meaningless. The result was an outraged court and a nullified demutualization.

Doyle v. Union Insurance Co., a case in Nebraska, involving demutualization accomplished via bulk reinsurance had some of the same "bad smell." There, the insurance commissioner's approval of the bulk reinsurance agreement was disregarded by the court.

You have to be able to pass the smell test.

My personal view is that a demutualization plan can pass the smell test without giving all the value of a mutual company to its policyholders. But you have to get legislators and regulators to go along with that approach, so it would be nice to have a case or two as precedent.

Today the problem is that the legal and regulatory systems' development of meaningful standards and rules is just beginning. Even though a small majority of states permit demutualization, the laws now on the books look primitive. What about the continuing need of the corporate entity? What about raising capital? What about the special needs of the larger mutuals who may have to go to the market in stages and can't afford to have millions of stockholders? What about takeover threats? The existing statutes deal inadequately or not at all with these important matters.

The most extensive work on a statute, which will take these matters into account, is going on in New York. The work of the New York companies and Insurance Department provides a window on the legal and regulatory perspectives of demutualization:

1. The bill would set forth the general contours of three methods of demutualization expressly sanctioned as fair and equitable to policyholders. Both the regulators and the industry recognize the importance of specifying permitted methods of demutualization, while incorporating flexibility wherever possible. The first method would permit variations on the "all stock to policyholders'" approach taken in other states. Stock itself need not be given. Instead, the company can sell the stock on the market and give

the proceeds to policyholders. This method also would permit a process of demutualization lasting as long as ten years. The second method would involve the creation of a permanent policyholders' preference account. The third method, to be available only to smaller companies, is based on a surplus payout.

2. The bill addresses fairness to policyholders by calling for a closed block of participating business, possibly excluding certain classes of group business, and allowing a variety of approaches to consider policyholders.

3. The bill would impose a one year statute of limitations on lawsuits. Unfortunately, a statute of limitations is not necessarily going to stop lawsuits. As we know from Union Mutual's experience, lawyers won't wait for a demutualization plan to go through the approval process before acting; they will sue to have it aborted. If they are unsuccessful in stopping it in advance, they will sit on the steps of the Insurance Department, ready to call their associates at the courthouse to have papers filed the moment the plan is approved. But the New York bill contains something else that is designed to deter would-be plaintiffs: it would empower the courts to require plaintiffs to put up security for the insurer's reasonable expenses in defending the suit, which could be substantial.

4. The bill has a provision which would prohibit any person, or persons acting in concert, from acquiring more than 5 percent of the insurer's stock within the first five years after the conversion is completed. The law is strengthened by provisions that would allow the insurer and others to sue to enforce the prohibition and would automatically disenfranchise shares of stock exceeding the limit. True, the superintendent would be able to waive the anti-takeover protection, but this is an option the Insurance Department wanted, and its inclusion should help save the state law from challenge on the ground that it is preempted by federal legislation (the Williams Act).

5. The Insurance Department is given explicit review power over conversions of foreign companies doing business in New York. This provision stops just short of saying that the Insurance Department can pull the license of a demutualized foreign company if it does not like the plan, but anyone reading the provision is likely to find an implication to that end.

6. In its preamble, the bill recognizes the state's authority "to bring within the scope of its regulatory review and approval any material concepts related to demutualization, unanticipated as of the effective date of the bill." This means that the basic outlines of the methods are to be as prescribed, but the Insurance Department has authority to require plan modifications to take into account "new concepts."

If the New York bill were enacted in its present form, would it work? We would need at least one demutualization under it, preferably of one

of the six or seven larger New York companies, to begin to find out. But it is probably as well thought out as it can be. It represents the judgment, one the legislature can reasonably share, that two companies may take different views of what they hope to accomplish and choose different methods as long as the value distributed to policyholders passes the fair compensation threshold set by the law. The more the policyholders get out of a demutualization plan, the safer it will be from a successful challenge. But companies frequently take the riskier of two roads in making business decisions.

It is almost certain that the bill will not be enacted this year. Several key legislators have indicated that public hearings will be held on the bill even after the industry and Insurance Department agree. It is possible that such hearings will generate pressure to make some changes, but I hope that the bill's basic approach will be retained.

The New York bill is worth emulating in other states. A demutualization bill going through the Iowa legislature reflects the approach taken in New York. Of course, we will know more about what can and cannot pass muster in a demutualization after Union Mutual's plan is approved. It will no doubt be tested in court, a prospect that its lawyers are prepared for. Optimists think the Maine Commissioner will hold a public hearing on the plan this fall; I would not be surprised to see the hearing delayed until 1986. I expect Union Mutual to succeed in its conversion, though perhaps with changes in the plan to increase the consideration paid to policyholders.

Despite what the statutes generally say, regulators and courts will be flexible in responding to a hardship case. The Inter-State acquisition by Central Life is a case in point. Central Life will buy Inter-State's assets and liabilities, convert the company and acquire it as a shell. This structuring is unusual, but regulatory approval presumably means that such a course is deemed necessary to protect policyholders and that this plan is considered better than the Equitable of Iowa deal.

The traditional thinking in tax law consideration is that you should be able to structure a demutualization so that it will qualify as a tax-free event. But skirmishes between the industry and the Internal Revenue Service (IRS) and Treasury are breaking out all over.

MR. MURCH: In addition to his basic responsibilities as the executive in charge of New York Life's Corporate Actuarial and Tax Department, Mr. Shur is also a key, hard working member of the Society of Actuaries Committee on Conversion of Mutual Companies to Stock Form. Additionally, he has been actively involved in the recent discussions with the New York Department, which have led to the development of the New York Demutualization Bill. Mr. Shur will give us some perspective on the actuarial issues involved in demutualization.

MR. WALTER SHUR: The bill is agreed to by both the Insurance Department and by the Industry Association in New York, except for one specific provision, which I will mention as I go through a description of the bill.

If you want to demutualize according to Method 2 in the bill, you first have to set up a closed participating branch in order to protect the dividend rights and expectations of the participating policyholders. You have to put an amount of assets in that closed branch. The bill defines how you determine the amount of those assets. It is the amount of assets "which together with anticipated revenue from such business is reasonably expected to be sufficient to support such business, including, but not limited to, provisions for payment of claims, expenses and taxes, and to provide for continuation of current payable dividend scales, if the experience underlying such scales continues and for appropriate adjustments in such scales if the experience changes."

You have to put enough assets in the closed branch so that if current experience continues, you can pay the current payable dividend scale. If current experience does not continue, and is more favorable, then more assets will develop in the closed branch, and they will be paid out in the form of increased dividends. If future experience is worse, then there will not be enough assets to pay the current payable scale, and the scale will be reduced. The bill goes on to say that none of the assets and none of the revenue from the assets in the closed branch can go to the stockholders. We have sometimes referred to this participating account as a "walled off account" as if we were putting assets behind the wall, completely insulated from the stockholders.

All of the participating business must go in that account, with one exception: The company has the option of leaving out any or all of its group business. For the remainder of my description, I'm going to assume for simplicity that all of the participating business has been included in the closed branch. In actual practice, the group business would probably be left outside.

You next have to determine an aggregate amount, which is referred to as policyholder's equity. The way you get this aggregate amount is first to determine how much of the company's assets came from the existing participating policyholders. This is a retrospective calculation. Add up all the premiums and investment income, subtract appropriate items and determine how many assets you now have that came from the existing participating policyholders -- in contrast to assets you have that came from participating policyholders who are no longer with the company. The difference between the aggregate amount of assets and the amount of assets that you have put in the closed participating branch is defined as the policyholder's equity. The policyholders will be given that amount of money in some form, at the option of the company. The form may be common stock, cash, increased benefits, or increased dividends, but the value of what the policyholders get will be equal to the policyholder's equity amount.

One way of thinking about the policyholder's equity is to take a look at the amount of assets in the closed branch. That's not dissimilar to a generally accepted accounting principle (GAAP) reserve. Policyholder equity is roughly similar to GAAP surplus on the existing participating policyholders.

After determining the policyholder's equity, you then must determine a policyholder preference account. This amount of money is determined by taking the company's total admitted assets, subtracting the amount of assets put in the closed branch, subtracting the policyholder equity, and subtracting the reserves and liabilities on any nonparticipating business the company has which is not included in the closed branch. The policyholder preference account is the remaining assets of the company. You can think of it as the remaining surplus in the company. It's a statutory surplus, although it may not be too dissimilar from GAAP surplus.

The policyholder preference account is essentially the orphan surplus of the company. For most large mutual companies, most of that money has come from policyholders who are no longer with the company.

The policyholder preference account serves two purposes as defined in the New York bill. The first is that in the event of the liquidation of the company, the amount in the policyholder preference account will be paid as a first priority to the participating policyholders who were there on the date of demutualization and are still there at the time of liquidation and as a second priority to any other participating policyholders.

The second purpose of the policyholder preference account is that no dividends can be paid to stockholders from that account. Also, the money in that account cannot be used by the stockholders to repurchase shares. In other words, that amount is going to stay in the company. It's not dissimilar to a minimum capital requirement. It cannot be removed by the stockholders, but the earnings on the policyholder preference account are available to the stockholders of the company.

The bill says that the policyholder equity cannot be less than the preference account. For example, suppose you did some calculations the way I described, and you found that the policyholder equity was 100 million dollars, and the policyholder preference account was 300 million dollars. When you apply this provision, the policyholder equity is 200 million dollars and the policyholder preference account is 200 million dollars. This is sometimes referred to as a safety net, and it assures that the policyholders will be entitled to at least half of all the surplus remaining after you take care of the dividend prospects in the closed branch.

Method 2 requires the company to sell shares of stock to the public to raise money. The bill says that the amount of money that must be raised is the estimated value of the company in the market. That might be the fair market value of the amount of money, which a fair and competent investment banker determines the market is willing to pay for the stock. This provision is to make sure that nobody is getting a windfall -- that they are paying, in fact, a fair market price for the company.

The policyholders are also given nontransferable subscription rights to buy the stock offered to the public -- unfortunately, at a 20 percent

discount. The 20 percent discount is what the industry and the Insurance Department and Governor's office can't agree on. It essentially makes the plan unworkable.

We have a method under which we established a closed participating branch, and we put money in it. The policyholders will continue to get dividends, similar to the dividends they would have gotten had the company remained mutual. Then the policyholders will get what is referred to in the bill as "policyholder consideration" in return for their membership interest or, loosely, "ownership" interest in the company. That consideration will consist of three things: the policyholder equity, the policyholder preference account, and the subscription rights to buy the stock being offered to the public -- to be the first in line to buy it at a 20 percent discount.

As an oversimplified numerical example, suppose we have a company that has 1.4 billion dollars in assets. You go through these calculations and find that the amount needed to go in the closed branch is 1 billion dollars. The policyholder equity turns out to be 200 million dollars. The policyholder preference account turns out to be 200 million dollars, which makes up the 1.4 billion dollars. This company has no participating business. Let's suppose that this company can earn 10 percent on its capital and surplus and 10 percent on any new money that comes into the company. But suppose that the public wants to earn 15 percent for this type of investment. After some simple algebra, you will find that the amount the public is willing to put into the company is 200 million dollars. The 200 million dollars that the public puts in will earn 10 percent; that's 20 million dollars. The new stockholders will own half the company because the policyholders are going to be given 200 million dollars worth of common stock; that's the value of the policyholder equity. The new stockholders bring in 200 million dollars. They each own half the stock, so they each own half the company. The new stockholders will get not only the 20 million dollars of earnings on the 200 million dollars they put in, but they will get half of the earnings on the policyholder preference account. That was 200 million dollars and the earnings are 20 million dollars giving the stockholders another 10 million dollars. They will be earning 30 million dollars on the 200 million dollars they put in, which is 15 percent.

This whole process is very actuarial. The Society has charged a Task Force on Mutual Life Insurance Company Conversion (of which I am a member) "to examine the actuarial issues involved in converting a mutual life insurance company to a stock form of ownership and to produce a record of this examination." The task force is chaired by Harry Garber and consists of actuaries from large and small companies, from the U.S. and Canada, and from the consulting field. One actuary is with an investment banking firm. Early in the task force's deliberations, it realized that it needed some kind of a sophisticated computer model to test out different concepts in demutualization, used as an educational tool, to later illustrate different plans of demutualization, and to test different plans of demutualization in terms of variations in experience and so on. That model, as yet unfinished, was developed by Milliman & Robertson. It is being tested now, and we are parameterizing it.

The model built up a company from scratch. Over a seventy-five year period, it kept issuing only whole life insurance. The model had an interactive dividend process so that every year the dividends that were paid to the policyholders were based on a management policy to build toward a 7 percent surplus ratio and, at all times, to be sure surplus was above a certain amount and below some other amount.

At the end of the seventy-five years, the company was then demutualized. Because we had all of the facts in the model, we were able to determine precisely how many assets were needed to go in the closed branch. This included as benefits the present value of the current payable dividend scale at that time. We then were able to determine the policyholder equity and the policyholder preference account. We ran that company for another seventy-five years after demutualization to see what the effect of changes in experience would be on the closed branch. How would that affect the policyholder's dividends? We ran it with changes in interest, mortality, and lapse rates.

The primary question has had to do with lapses. The Insurance Department has been concerned whether the lapse profits, arising when people terminate, would get to the participating policyholders through the closed branch. Where are the statutory reserves? They're held someplace. When you have lapses and you release the statutory reserves, you have large profits. Do the profits get to the policyholders? We ran the model out to show that the policyholders would be getting all the benefits arising from the additional lapses.

We expect to learn a lot from our computer model about the capital structure of an insurance company. Where does the capital come from? It obviously came from the policyholders in the model company. Should policyholders leave any permanent money with the company after they have gone? Is there a revolving fund situation where, after the policyholders are gone, they haven't left a penny with the company? The model gives us good access to facts that relate to that question.

This is the most complex issue that I have ever been involved in, and it covers a long time in the business. The outline of the preliminary draft of a preliminary proposed report of the task force shows the various topics and sections where some interesting questions are raised:

1. General Introduction

2. Identification of key elements of conversion plan

   a. Maintenance of dividend expectations
   b. Consideration to policyholders
   c. Conversion accounting questions
   d. Capital market considerations

3. Maintenance of Dividend Expectations

   a. Description of general theory -- Why? How?
   b. Closed branch approach -- For which lines? What form? For separate accounts or some other form?

i. Selection of assets to go in the closed branch.

For this hypothetical company 1 billion dollars of assets is to be placed in the closed branch. Which assets? Is it all right to put a large amount of low yielding assets, which could do the job as effectively as a small amount of high yielding assets? What do we do about assets, which represent the value of subsidiaries that sell nonparticipating insurance? Are those appropriate to put in the closed branch? Do policy loans belong in the closed branch? Should the assets, in fact, be identified, or should they be just a general portion of all of the assets in the company's general account?

ii. Charges to be made against the closed branch.

What kinds of charges are appropriate? For example, is it appropriate to charge the closed branch with expenses of running the agency operation or some part of the agency operation? Is it appropriate to make any kind of capital charges against the closed branch? Should those policyholders be asked to leave any permanent money with the company since the company surplus protects everybody, including the participating policyholders in the closed branch? How should federal income tax charges to the closed branch be handled?

There's an add-on tax on equity, which applies to a mutual company, but not to a stock company; it should disappear on the day of demutualization. You could put enough assets in the closed branch -- a smaller amount of assets recognizing that there will be no add-on tax after demutualization. That smaller amount of assets will take care of paying benefits, expenses, and taxes and then provide for the current payable dividend scale. Or you could put a larger amount of assets in the closed branch that contemplates, as current experience, that the add-on tax will continue to exist. Then, when it does disappear, there is an improvement in experience, which means you can increase policyholder dividends as a result of the disappearance of the add-on tax.

Whichever way you do it, the existing policyholders are going to get the benefit of the disappearance of the add-on tax. The only question is whether they get that benefit tnrough increased dividends or whether they get it in the form of equity in the company.

c. Methods for other lines of business

d. Actuarial techniques and measurements

i. Certification of equity and adequacy of the closed branch assets at conversion

ii. Certification of the closed branch operation on an ongoing basis

iii. Certification of dividend treatment for those participating policies left outside of the closed branch

4. Policyholders' Consideration

How do you get the aggregate amount? How do you build up the historical assets? You are dealing only with survivors. Therefore, there have been no deaths, so there are no death claims to subtract. It seems obvious, however, that these people should be charged somehow for the cost of insurance.

There is a whole series of accounting considerations: What's the accounting model for all this? How do you treat the closed branch on an accounting basis? How do you treat old nonparticipating business which is not in a closed branch?

You have post-conversion balance sheet adjustments. What's the impact on the income statements of different methods of paying the policyholder consideration? How does that affect the operations of the company?

Then there are a whole series of capital market considerations. The list goes on and on, including participating business that might be issued after demutualization, which does not go in the closed branch. How is that handled?

I hope that you agree this is a very actuarial process.

MR. MURCH: Mr. James H. MacNaughton is Vice President in the Financial Industries Group of Salomon Brothers Corporate Finance Department in New York City. He's been with Salomon Brothers since 1979, initially working with corporate finance matters of all types in all segments of the financial service industry. Since last year, however, he has been specifically responsible for all of Salomon Brothers investment banking activities for the insurance industry.

MR. JAMES H. MACNAUGHTON: The legal, accounting, tax, actuarial, and moral questions of demutualization should be covered by other professional disciplines. Investment bankers are more concerned with securities valuation, sale of securities, liquidity of those securities, and transfer of securities (common stock) to friendly, unfriendly, passive, anxious, or neurotic hands as the situation may dictate.

An insurance company may want to convert from a mutual form of ownership to a stock form to meet a number of financial and other objectives. Less traditional reasons can be significant stimulants to the decision-making process. Three of these are (1) to allow for change of control of the mutual company in good times or bad; (2) to develop a higher profile for the company's businesses through financial reporting and other market relations; and (3) to facilitate the understanding of

the company for outsiders, as outsiders (potential securities investors, credit rating agencies, and joint venture partners), begin to understand stock company structures, motives, duties, and responsibilities better.

Additionally, from a financial point of view, many think the mutual form of ownership is antiquated. It is believed that a consolidating and changing insurance industry will leave most mutual companies financially impotent -- the theory being that access to capital is real corporate flexibility. As tomorrow's financial services providers evolve, corporate (capital) flexibility will be imperative to react to, or more importantly, to lead to change. Economics of the insurance business have changed, and therefore, flexibility to move capital around the organization is also vital. It is necessary to facilitate this capital transfer throughout the corporate organization and to facilitate growth by acquisition through an upstream holding company. This structure solves many accounting and regulatory problems, which may come about in expanding the corporate organization.

The aggregate market value of the thirty-three life, thirty-three property-casualty, and nine multiline companies on the New York Stock Exchange, American Stock Exchange, and National Association of Securities Automatic Quotation System (NASDAQ) was approximately 51.3 billion dollars or 2.9 percent of the aggregate market values of these three markets at year-end 1984. Most securities analysts expect that institutional portfolio managers will maintain their current investment weightings in insurance stocks for the next year.

During 1984, this has averaged about 3 percent of institutional portfolios. Total statutory surplus of all mutual life insurance companies at December 31, 1983, was approximately 17.4 billion dollars, or approximately 35 billion dollars on a GAAP basis. This represented 33 percent of the statutory surplus of all life insurance companies in the United States.

Financial Planning of the Demutualization Project

In embarking on the financial planning process, the best place to begin is at the end. Design the company, which you ideally would like to have after the process is complete. The holding company structure should be an important part of this design because it is an ideal structure for building financial flexibility into the organization. It will enhance the ease of moving corporate capital within the organization, while centralizing financial strength. Additionally, it will help to substantially alleviate subsidy accounting and other problems.

When planning the model or target stock company, you must develop an ideal capital structure and ownership profile. The company's capitalization should be built to support today's business and provide flexibility for the development of adequate capital for future activities. It should be constructed to protect existing and future shareholder and creditor values, while providing the strongest credit rating within the

context of appropriate financial flexibility. Additionally, the capitalization should be built to facilitate raising new and additional capital.

As a second part of the financial planning process, careful thought should be given to constructing the form of the public entity. The demutualization project could be partial or total. Within this context, a number of considerations are vital in determining which businesses and insurance product lines should be included in the public company and what the successor mutual company would look like once public ownership for all or a portion of its business has been formed.

In a partial demutualization, selection of the types and sizes of business, which are to be included in the public company, is particularly important. Relative size of the new public company compared to the mutual company must be a meaningful part of the total enterprise. A good example is Lumberman's Mutual-Kemper Corporation. Kemper was designed to facilitate a number of business activities outside of the insurance business while allowing those activities to interrelate with Lumberman's business. An organization too small to make a meaningful difference to Lumberman's would probably not be worth the effort in today's world.

The financial implications of a partial or full demutualization are especially important. The process will likely require the inclusion of some kind of walling-off concept, in both theory and practice. Allocation of predictable future profits will protect a new stock value. In addition, it's necessary to make sure that the public has something to buy other than just "good looks." Therefore, in considering full or partial demutualization, businesses included in the public company must have attributes which are conducive to public ownership: (1) high-growth product lines; (2) businesses with high-operating leverage and selffinancing capability; and (3) businesses with predictable earning streams. The major objective is to make the company understandable.

A public company built with these attributes should trade in a comparable price/earnings (P/E) and price/book value (P/BK) range to existing public companies. Historical market trading ranges may be characterized as (1) life company P/E and P/BK normalized trading ranges being 5 to 8 and 0.8 to 1.1, respectively, for the last five years; and (2) property-casualty company P/E and P/BK normalized trading ranges being 6 to 9 and 0.9 to 1.2, respectively, for the last five years.

Finally, the financial planning of the demutualization project must be considered in light of a contracting insurance industry. A need for flexibility for acquisition of control in demutualizing small-lingering companies or problem companies is imperative. The currently eroding values of many going concerns necessitates ways to protect historically developed values. Changing regulation, which may deter flexibility in the mutual company, also clouds the financial environment today for insurance companies. It remains uncertain whether diversification is

good or necessary in order for a company to compete. The availability of third-party investors could be enhanced by converting the insurance company to a stock form from a mutual form of ownership.

Considerations Relevant to the Valuation Process

The topic of valuation is involved. From a technical or quantitative standpoint, a number of considerations may be important. These may be (1) actuarial matters; (2) stock market; (3) going concern or goodwill (intangible) value; (4) liquidation value; (5) change or transfer of control value; (6) going private or concentration of ownership value; or (7) value inherent in investment liquidity.

Additionally, the political aspects of value of a company may be more interesting and important. A number of political values include (1) the public profile value (2) distribution of equal value to all policyholders; (3) management control or concentration of control with insiders -- management and directors; and (4) minimizing the potential for unjust enrichment to unaffiliated groups -- windfall profits.

Who owns the company's goodwill (going concern value), and how much is there? This may differ in theory and practice. There is a need to develop an equitable approach to "get deals done" without creating substantial "windfalls" to potential shareholders. Depending upon the definition of the policyholders' equity interest in the converting mutual, the beneficiary of some portion of the goodwill may be the reorganized company itself.

Mechanics of Going Public

The technical aspects of going public should be covered by other professional disciplines. The keys to the successful sale of the stock of a newly-converted mutual include a number of things. First, the ease of understanding the issuer, its prospects, and the predictability of its earnings and dividend growth is imperative. Distribution of stock in exchange for all of the policyholders' (and its other rightful owners') ownership interest (and the going concern value of the company) in as efficient a manner as possible -- or at least definition of full allocation of ownership -- is imperative.

There will be a difference in developing a market for a large as opposed to a small company initial public offering (IPO). In a large IPO where all of the securities are issued directly to policyholders, a less satisfactory secondary market for the company's stock may develop. Additionally, a policyholder cash election in the demutualization process could produce the need for a larger issue or series of offerings which must be managed carefully.

The size of the IPO and perceived future liquidity of the stock sold in the secondary market, will impact the stock price today. Size and price constraints (minimum and maximum price) will depend upon a number of things: (1) the operating and financial characteristics of the issuer; (2) vital institutional investor participation for a large issue; (3) enhanced desire for stock market price stability out of the issue by

the breadth of ownership and secondary market liquidity; and (4) today's limited investor universe for insurance stocks causing the value of and the ease of access in the market to fluctuate. Finally, equity must be given to the stock market. The market will eventually place the value on the company, not some "independent" third party.

The conversion process initially will result in a large number of shareholders creating substantial administrative problems and costs. The potential need for methods to consolidate shareholders is apparent. Additionally, the need for a cash election for policyholders in the conversion process may create additional near- and long-term financing needs. Overhang of future stock and security sales will deter protecting today's market values.

In planning the initial public offering, future stock issuance flexibilities should be considered. That flexibility may be necessary for shelf-registration or other techniques for continual sales to take care of larger company conversions. Future stock flexibilities might be necessary to provide price competitive outlets for policyholders who receive a few shares in the original conversion distribution and to provide a method to finance the original cash elections by policyholders in the original conversion. Finally, the need may arise for additional statutory surplus to be added to the insurance company immediately -- obviously one of the primary reasons for converting in the first place.

Primary stock insurance flexibility subsequent to the IPO is obviously a key reason to convert. Traditionally, the reason most given for new stock sales is to finance both internal and external business growth. Constraints on raising additional (new) capital, however, whether debt, preferred stock, or common equity, will certainly depend upon the size of the issue and the company's total market capitalization. You can't sell all the stock that you want to just because you are a public company. There has to be real value behind what you are selling.

Business diversification will affect stock prices also, depending on the transaction. Logical acquisitions may be well received by the stock market, and therefore, stock values will be maintained or go up. Depending upon the market, stock issues for "unknown" future transactions are likely to be poorly received if they can be sold at all. There would definitely be no interest from the public in businesses which complicate the picture.

Once you become a public company, there are a number of other considerations which revolve around dealing with the financial community and which will appear in different stages. The first stage will be implicit in the selling of the IPO of common stock. Continuing investor relations will become an important part of future senior management activities. Future financial disclosure to new public constituencies, such as stockholders, the financial press, and academics, will require more time and care.

Acquisitions in the insurance company's existing business normally will be viewed as fine. Diversification outside of your basic business will be more critically judged. Additionally, vulnerability to unwanted

change of control (hostile takeovers) must be monitored. History shows, however, that insurance companies are questionable targets for corporate raiders, and therefore, hostile takeover probably will not be a big problem.

Finally, a sensitivity must be maintained for the trading value of the company's stock, whether it be secondary market levels or the value of new stock given in any transaction. Subsequent trading values will be affected by interest rates, inflation perceptions, fit in the financial services industry, liquidity, supply, and competing stock segments like banks.

In conclusion, I would like to editorialize on a number of points.

(1) Mass demutualization of the insurance industry may be a significant factor in how the financial industries revolution develops in the future. A huge amount of assets may become "unlocked" for a number of different needs which heretofore have been impractical or impossible.

(2) A discrete market for insurance stocks exists. The effects of demutualization on stock prices of existing public companies, and therefore on new issues, may be substantial. Whether there will be enough funds to meet the demands placed on the stock market for potential insurance company IPOs is the real question.

(3) Change-of-control demutualizations will have to be reviewed in the context of protecting shareholder values. Stock companies have dealt with this for some time. Eroding values of smaller companies, who will inevitably be unable to compete in the future, have to be considered. Consolidation should help to eliminate redundancy and may ultimately help to protect values.

(4) Some parallels finally can be drawn to the thrift conversion experience, but there are still substantial differences. We ought to keep our eyes on developing a set of rules and perspectives specific to the insurance industry and not try to draw too much correlation to the thrift industry experience.

In the short run, demutualization will be used for bailing out failing companies, or transferring ownership of smaller, floundering companies. The big companies will be much slower to move, if they move at all; they don't need to yet. Obviously, the process is very complex and highly political. In any event, the process should be kept as simple as possible when it is approached at all. It's important to remember that a lot of people must understand the effects, not only on the converted company, but also on them as new shareholders. Remember how many policyholders exist today and how long it took to create those policyholders.

MR. SOLOMON GOLDFINGER: In the current bill, are there any special provisions for either recently terminated policyholders or recently issued policyholders in determining the policyholder equity?

MR. SHUR: The current bill applies to policyholders who are there on the date the demutualization plan is adopted.

MR. FRIEDMAN: Yes. The theory on the property and casualty side (many states don't distinguish between life and property and casualty (P&C) companies in their demutualization laws) -- is that property and casualty companies have an easier time getting rid of policyholders than do life companies. If, in a particular circumstance, there is some evidence that a life company has been encouraging policyholders to lapse, the Insurance Department will probably make things difficult for the company.

MR. GOLDFINGER: What about a recently issued policyholder? If you go through the mathematics and look at the present values, it turns out that he effectively gets the present values of his future profits in his equity. Would he still be entitled to that?

MR. SHUR: If he is there on the date of adoption of the plan, even as a recent policyholder, then he would get some equity.

MR. GOLDFINGER: The process sounds like a big piece of what would make the company attractive to the market is windfall earnings on the preference account. What is the market's reaction to that in relation to other existing companies? When you think of a company as good, its real earnings should make it attractive. To what extent is this windfall earnings going to make these companies look more attractive than existing stock companies, or to what extent are the earnings of existing stock companies derived implicitly from earnings on just enough money that's sitting there?

MR. MACNAUGHTON: Theoretically, the stock market and certainly the stock analysts are going to distinguish source of earnings from two distinct sources. The first source that you just talked about is fairly predictable.

The going concern part of the business, or the company's core life insurance business, will be analyzed and projected just like any other company. The two parts would be put together. The first part will put a floor under predictable earnings, and the second part will be the swing factor. This will eventually, or even initially, be factored into the value of the stock and traded that way. Let's say that you have a predictable stream of earnings from that pool of $10. You have an earnings potential on a normalized basis of $20. The company sells it at a P/E ratio of ten times earnings. Earnings are $30. Therefore, the stock price ought to be $300. There may be some discount off that $300 because the first $10 isn't going to grow. It's not going to have upside potential other than just a nominal investment rate. People who buy stocks are willing to take some risk to get a greater return.

MR. ROBIN B. LECKIE: In Mr. Shur's and Mr. Murch's capacities as chief actuaries for their companies, how could they argue not to demutualize? Under the New York law, following demutualization, you can provide your policyholders with all they could have received as participating policyholders of a mutual company through the provisions

in the walled-off account. Additionally, they can receive the policyholder equity, which they would not otherwise have received if you do not demutualize. Furthermore, the policyholder equity is not just restricted to that which they may have contributed as policyholders during the course of their time with your company. The New York law also requires that policyholder equity be at least equal to the preference account, which for many companies writing a lot of nonparticipating business could exceed significantly the otherwise calculated policyholder equity.

How will you meet the "smell test" if you don't demutualize and pass this windfall through to your policyholders? In your capacity as chief actuaries, do you not owe it to those policyholders to demutualize?

MR. MURCH: The argument is parallel to the one that exists aside from the question of demutualization and which comes up from time to time in a mutual company: "Why don't you stop writing new business?" In other words, if there's one thing that could on the surface seem to benefit financially the existing in-force policyholders, it would be to cease writing new business or to take steps to move in that direction. Then, in the ensuing years, the theory says that the financials are going to look terrific from the standpoint of the in-force policyholders. But the going concern objective is to continue to write new business so that you are able to continue to make investments and reduce unit expenses below where they would otherwise be in the absence of new business. This has been and continues to be an important factor in managing the long-range function of mutual companies. The question of whether to demutualize or not to demutualize is a subset of that. Mutual companies should not be pushed into demutualization just from the standpoint that if you don't demutualize, you may be keeping something from the in-force policyholders. The fact is, that by demutualizing, you can also be exposing the in-force policyholders to new risks and costs, such as those flowing from the disadvantages of demutualization already mentioned.

MR. SHUR: There is a huge cost for demutualization. At least one large company has said the cost would be a nine-figure number. A large amount of management time would be involved and devoted to the process which would take several years. In history one large company mutualized over an eight-year period. It started in 1917 and finished in 1925. What impact does this length of time have on the existing policyholders and on their dividends and dividend prospects? Will the time of the company management be better or worse spent on demutualization? That has to be judged in the long-term interest, as the policyholders depend largely on the management of the company.

MR. FRIEDMAN: From a legal standpoint, if the law is passed, can somebody bring a lawsuit to compel demutualization? Or can somebody come up with an enormous amount of money and say to the board that he will pay a tremendous premium to demutualize?

It is a complex, business-judgment question. There's a parallel situation in a stock company context when you have companies whose

market value is below their liquidation value. The question is whether a stockholder might be able to compel a split up. I'm not aware of any case that has held stating that a corporation has a clear duty to self destruct. The court would respect the business judgment of the directors.

MR. DAVID J. FISHBAUM: If you had a mutual company that for some odd reason got rid of all of its statutory liabilities, assets, and surplus, could that company capitalize in the market, using how it produced earnings based on the surplus it did have as its track record?

MR. MACNAUGHTON: Any company that wants to borrow or raise equity from the capital markets needs to have a clearly defined use for those funds and a track record that will prove to the investor that the company will adequately employ those funds and provide a reasonable return.

MR. FISHBAUM: We have a track record given that mutual companies have been around and produced money, but they produce it to the policyholders.

MR. SHUR: In this bill, Method 3 is available only to the small companies with less than 45 million dollars in surplus and with industrial business in force. The amount of money, which is put in the closed branch, are the statutory reserves, and the amount of money, which is given to the policyholders, is the statutory surplus. In effect, all the company's assets are given to the policyholders in their role as policyholders. The company now goes into the market to raise stock. There is no preference account. There are no existing earnings on the assets that go to the new stockholders. All they are going to get is the ability of the company to produce.

MR. MACNAUGHTON: If you are setting up a company with no surplus, but you have the going concern aspects of the company -- the agency force, the capability to underwrite, the administrative capabilities, and the investment capabilities -- you don't have to have X number of dollars to raise X number of dollars.

MR. FISHBAUM: You've got these people who have entered into an agreement, which says we will provide them insurance at cost. What you are doing is taking the earnings of the assets and giving it to shareholders who have come in and, more or less, taken those assets. As management you've sold those assets without any benefit to the policyholder. I'm not sure that is appropriate. Why can we not just completely wall off our assets and leave it to the policyholders? The orphan equity is what's at stake here. We should give it to the existing and maybe the future participating policyholders if you continue to sell participating insurance rather than give it to some shareholders who start buying it at probably a lower rate than the participating policyholders deserve.

MR. SHUR: I don't describe it as giving anything to the stockholders. The stockholders are paying a fair price for the company. The

company should not use this particular method unless it needs and wants to raise capital. If it wants to raise capital, it needs to have a method. When the law is passed that permits demutualization, it's admitting that public policy is served by that purpose and that it's appropriate for a company to raise capital.

MR. FISHBAUM: Do the policyholders get anything from the capital coming in for that preference fund?

MR. SHUR: Under the method that I describe, the participating policyholders are getting far more than they ever would have received had the company continued as a mutual company. Since that's the case, then maybe the company should demutualize. If you follow through what I describe, you will see that the participating policyholders will not have left one cent with the insurance company by the time they're gone. We've taken all the assets accumulated by the existing participating policyholders and insulated them. Any future earnings on those assets and any future profits on the participating business are behind the wall. By the time those policyholders are gone, they will have had their insurance at cost. If the company had continued as a mutual company, this probably would not be true because the only way mutual companies raise capital in order to be able to grow is from the participating policyholders. There is a charge that's made, sometimes implicit and sometimes explicit. Participating policyholders do leave money with a company by the time they're gone.

MR. FISHBAUM: You're not going to give them any earnings from the capital that the shareholders brought in. They've lost the earning power of the preference fund.

MR. SHUR: The policyholder equity is something they would not get if the company had continued as a mutual company. They're getting good compensation for "their ownership interests." Now, what are their ownership interests? The right to vote is an ownership interest; not many people vote in large mutual companies. It is a question of how much that interest is worth. I think they're being well compensated for the rights they have outside of their contractual rights.

MR. FISHBAUM: These participating policyholders deserve insurance at cost. They have assets that they're not earning any interest on, and that's the orphan surplus asset. They're not getting that anymore, and they had it before demutualization.

MR. SHUR: They may or may not have had it before demutualization because those assets may be what created the capital that the company has that enables it to grow. What is the definition of cost? If you take a policy issued in 1940, add up all of the premiums that that policyholder paid, credit him with investment income on the assets that he's generated, and subtract appropriate expense charges and cost of insurance, that defines the cost of the insurance.

MR. SHUR: I raised the question about subscription rights at a 20 percent discount and said that the industry couldn't deal with that. We

are talking to the Insurance Department now trying to find some better way to accomplish its objectives. Why would that be a problem?

MR. MACNAUGHTON: The stock market will have an inherent problem in the distribution of common stock for a newly converting mutual insurance company in which there are different interests on the part of potential shareholders. Giving someone a subscription right with a discount with the potential of exercising their subscription right at X dollars and immediately selling it into market for Y dollars plus something and creating a quick gain will probably cause the value of stock to trade artificially below the level at which it would normally trade if this overhang of potential quick profit takers didn't exist. It is a problem that any new shareholder is going to have.

Let's say that the stock can be sold for $20 a share and that the policyholder has a subscription right for 20 percent discount of that or $16 a share. A sophisticated shareholder may be likely to take some portion -- whatever portion of that $4 differential he can get -- fairly quickly because it's free money to him. The overhang of that quick movement or volatility of new shares coming into the market will artificially depress the $20 share price level down to a number, which is below where it ought to trade and, therefore, will affect distribution, at least from a value standpoint, to people who are outside the group of policyholders or other constituencies that have the subscription rights.

MR. MURCH: If that happens, and you ended up temporarily at an $18 figure, then suddenly you're in violation of the 20 percent discount.